AFMA Submission
Carbon Pollution Reduction Scheme
Green Paper

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1. AFMA and the Carbon Pollution Reduction Scheme

The Australian Financial Markets Association (AFMA) is pleased to provide comment on the Carbon Pollution Reduction Scheme (CPRS) Green Paper.

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.

AFMA’s work on carbon trading involves two principal areas:

(a) 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

(b) Technical implementation measures – Designing standardised documentation, market revaluation data and trading protocols to support the over-the-counter (OTC) markets.

This submission relates to the first area. AFMA is undertaking the second area of work on a gradual basis, with effort increasing as greater certainty emerges about the detail of the Scheme. Work to date has largely focussed on the development of OTC derivatives documentation.

2. The Framework for CPRS Market Policy

AFMA’s work on the CPRS involves analysis of a range of complex, separate matters that are interconnected in the operation of the Scheme, so defining some key terms will provide a coherent and consistent framework for this task; especially by drawing a distinction between the “Scheme” and the “Market”.

The **Scheme** is the entire body of policy, objectives, institutions, rules etc that define the CPRS.

The **Market** is the transactional space 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 Scheme** can be generalised as achieving least-cost emissions abatement according to targets, timeframes and scope determined by Government.

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 Scheme.

**Scheme 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 Scheme 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.

### 3. 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:

(a) The Market should have scale and scarcity
   - sufficiently large and priced to attract risk capital, which is critical for liquidity

(b) The Market should have many willing buyers and sellers
   - so as to form prices efficiently; buyers and sellers can include liable emitters, traders, investors and offshore entities

(c) The Market should facilitate competition in the provision of market services
   - so as to increase trading opportunities, reduce transaction costs and promote innovation

(d) The Market should not have asymmetric information or concentration of buy-side or sell-side demand
   - so as to form prices efficiently

(e) 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

(f) The Market should deliver dealable price signals
   - dealable 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

(g) 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; Scheme design should not contribute to persistent extreme contangos or backwardations
(h) 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
(i) 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
(j) The Market, through market operators and the National Greenhouse and Energy Reporting System (NGERS), 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
(k) The Market’s design should be as simple as possible
- straightforward, transparent rules improve market access for potential participants and make market regulation easier
(l) 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 overriding requirement for the efficient forward market necessary to ensure credible price signals, as inputs to abatement investment decisions, is regulatory certainty. One of the shortcomings of the National Renewable Energy Target (NRET) scheme was uncertainty in the market approaching periodic reviews, as the outcomes could range from no change to abolition of the scheme. This inhibited forward trading past the review date. We note that the Green Paper sets out several timetables for setting of targets, caps and gateways, as well as review schedules. It is critical that, once formally adopted (which should be done as soon as possible in all cases), these timeframes are not altered. Political expediency must not compromise Scheme credibility.

The comments and recommendations in this submission form an integrated approach to the development of an effective CPRS, so the submission should be viewed in its entirety. Changes to any aspect of the suggested approach may require modifications to other elements of it in order to achieve the desired policy outcomes.

4. AFMA Responses to Specific “Preferred Positions”

4.1 Framework

1.2 Design options are to be assessed against the following assessment criteria:
- environmental integrity
- economic efficiency
- minimisation of implementation risk
- policy flexibility
- promotion of international objectives
implications for the competitiveness of traded and non-traded industries
accountability and transparency
fairness

AFMA supports these design options as they should provide the regulatory certainty and other conditions necessary for an efficient market (as outlined in the introduction above).

Complementary measures should target a market failure that is not adequately addressed by the scheme, or that impinges on its effectiveness in driving emissions reductions. In some circumstances complementary measures may be transitional because although they may be necessary to address a specific failure in the short to medium terms they are not expected to be helpful in the longer term. [page 82]

Members have emphasised that the NRET scheme should be designed in conjunction with the CPRS, given the close link between the two. For instance, any NRET failure will increase the burden on the CPRS as the shortfall would impose an extra cost on CPRS liable entities.

4.2 Coverage

2.1 All greenhouse gases included under the Kyoto Protocol - carbon dioxide, methane, nitrous oxide, sulphur hexafluoride, hydrofluorocarbons and perfluorocarbons - would be covered from scheme commencement.

AFMA supports the initial broad scope of sectors and gases as it will provide market scale, breadth, depth and liquidity. This will promote a more efficient market that will help to meet the objectives of the Scheme.

2.2 In general, the emissions threshold for direct obligations under the scheme would apply to entities with facilities which have direct emissions of 25,000 tonnes of carbon dioxide equivalent a year or more. Different thresholds may be required for the waste sector and synthetic greenhouse gases.

2.3 Stationary energy emissions would be covered from scheme commencement by applying scheme obligations both to facilities with direct emissions of 25,000 tonnes of carbon dioxide equivalent a year or more and to suppliers of fuel to small energy users.

Whilst recognising the difficulties in measurement in some sectors (notably agriculture), AFMA recommends wide inclusion of sectors. However, leaving agriculture uncovered in the early stages of the Scheme does not materially reduce the size of the market.

AFMA supports the defined point of obligation, except that a large user opt-in for transport fuels should be further examined as this may benefit the market by broadening participation.

AFMA supports emissions thresholds that are low enough to ensure a large number of market participants, as this would broaden the market base and promote good market outcomes. However, we acknowledge that a balance
must be struck to avoid placing an undesirable compliance burden on smaller entities.

2.9 Carbon that is transferred to carbon capture and storage (CCS) facilities would be netted out of the originating entity’s gross emissions. Scheme obligations for fugitive emissions—from transport of the carbon and from the CCS facility—would be imposed on the operator of the CCS facility.

AFMA supports the proposed treatment of CCS emission reductions and emissions to the extent that it deals with operational CCS emissions. However, we suggest that the Government should clarify who would hold the liability in respect of a failure in the “Storage” part of CCS.

2.19 The Government is disposed to include agriculture emissions in the scheme by 2015 and to make a final decision on this in 2013.

AFMA supports expanding the scope of practical coverage as soon as possible and advocates early Government implementation of effective measurement regimes for excluded sectors.

2.20 All reforestation (as defined for the first commitment period of the Kyoto Protocol) would be included, on a voluntary basis, from scheme commencement in 2010, with design details to be determined.

2.21 Deforestation would not be included. Australian deforestation emissions have reduced markedly since 1990, largely due to increased protections against land clearing.

AFMA supports excluding deforestation, assuming that alternative non-market land-clearing restrictions makes an emissions reduction contribution comparable to that expected of the CPRS. We also support including reforestation as an opt-in to avoid unnecessary compliance costs for small emitters (see our response to 2.2/2.3 above).

2.22 The scheme would not include domestic offsets from agriculture emissions in the period prior to coverage of these emissions.

The Government would consider the scope for offsets from emissions sources that cannot be included in the scheme in 2013, following final decisions on coverage of agriculture emissions.

AFMA supports a domestic offset regime for all uncovered sectors until they are covered.

We also suggest that if the Government does not wish to create an offset governance regime, then it should allow projects to pursue JI Track 2 (ie under UN governance).

4.3 Carbon Markets

3.1 A carbon pollution permit (which will be referred to in legislation as an Australian emissions unit) would be an entitlement composed of various ‘rights’ contained in the carbon pollution reduction legislation. The main rights would be the right to surrender the permit and to transfer it.

The scheme regulator would issue only one type of domestic permit, called an Australian emissions unit (referred to in this green paper as a carbon
pollution permit).

The carbon pollution permits would be personal property.

Each permit could be surrendered to discharge scheme obligations relating to the emission of one tonne of carbon dioxide equivalent of greenhouse gas.

Each permit could be surrendered under the scheme only once.

There would not be power to extinguish permits without compensation, unless there had been misrepresentation or fraud by the holder against the Australian Government or the scheme regulator in the creation or issue of the permits.

Permits would be transferable.

Permit holders would only be entitled to surrender permits that they hold on the national registry. Legal title would be transferred only by entry in the registry.

The creation of equitable interests in permits would be permitted, as would taking security over them.

Each permit would have a unique identification number and be marked with the first year in which it could validly be surrendered (its ‘vintage’). It would not have an expiry date.

The permit would be uncertificated; that is, it would be represented by an electronic entry in the registry rather than by a paper certificate.

3.2 A permit could be held and traded by any legal or natural person (subject to verification of identity and measures to prevent criminal activity).

There would be no restriction on foreign ownership of permits, apart from any that might apply under a law other than the scheme legislation.

AFMA supports all of the characteristics listed above. Design elements like permit registration, legal certainty about property rights and transferability are necessary for a market to function, as they support market integrity and credibility of the Scheme, amongst other things.

3.3 The permit would be a financial product for the purposes of the Corporations Act 2001, but some adjustment to that regime may be required to fit the characteristics of permits.

AFMA supports the Government’s policy of ensuring the efficiency and market integrity of transactions in permits. AFMA also supports the Government’s view that market manipulation and market misconduct in relation to transactions in permits should be prohibited. These principles are fundamental to the creation of an orderly and efficient market.

AFMA does not believe that it is necessary to make permits a ‘financial product’ under the Corporations Act in order to achieve these policy objectives. Permits are not in the nature of a financial product. Treating them as a financial product will place a considerable cost on Scheme participants and increase the regulatory burden on business, without an offsetting benefit in the form of better regulation.

The approach adopted in the United Kingdom and New Zealand is consistent with Australia not including permits as financial products, but regulating derivatives in them in accordance with the Corporations Act.
Reflecting this approach, we do not believe that additional regulation is required, as the bulk of trading will take place in the derivatives market, which is covered by the existing law.

If additional regulation is contemplated nonetheless, it should be limited to that needed to achieve the objectives required. For example, if the Government considers it necessary to ensure that the provisions of Part 7.10 of the Corporations Act relating to market misconduct apply to transactions in permits, then permits could be included as financial products for that part of the Act only.

The development of a new market integrity regulatory regime specifically for the Scheme is not a viable option, as it would generate significant costs and potential regulatory overlap.

**Annex 1** provides a detailed explanation of our position.

### 3.4 Unlimited banking of permits would be allowed.

AFMA supports unlimited banking. Banking would reduce unnecessary price volatility over time, as, without banking, an excess supply in a given year would depress the carbon price significantly below its medium term level. Emitters could manage their compliance obligations more flexibly by having regard to their emissions profile over time, without compromising the credibility of the Scheme.

### 3.5. The scheme would permit a limited amount of short-term borrowing by allowing liable entities to discharge up to a certain percentage (less than 5 per cent) of their obligations by surrendering carbon pollution permits dated from the following year.

AFMA's position is that all emissions should be covered by surrendered units, as opposed to permitting a shortfall to be carried forward and covered in the following year. The latter could lead to continuous carry forwards. However, AFMA recognises that such a "hard cap" may result in short-term perverse price outcomes and, thus, we favour a mechanism that preferences short-term compliance supply volume without undermining the integrity of long-term compliance supply volume.

Our position effectively matches the Green Paper position, in that no short acquittal position can be carried forward without penalty but that a shortage of current year permits can be obviated by some (limited) use of next year's permits. This is particularly important in the early Scheme years when the number of units accumulated by emitters through banking would be limited and emission abatement activities have not come on-stream in significant volumes.

AFMA recommends the following:

1) Non-compliance should not be interpreted as an "illegality" as this would have ramifications for other aspects of business; for example “illegal conduct” clauses in loan documentation could be triggered.

2) Use of shortfall flexibility provisions should not be looked at as “non-compliance” (ie there is nothing “wrong” with this). An entity should not
be deemed to be in any form of default simply by borrowing next year’s permits.

3) Any cash “penalty” should be a tax-deductible cost. Tax treatment should be taken into account when setting the penalty level.

3.6 The scheme would have a compliance period of one year.

AFMA supports one-year compliance periods.

Whilst recognising that the choice of financial year over calendar year is a consistent approach to NGERS reporting and the majority of companies’ financial and tax year-ends, on balance AFMA favours alignment with the international market convention of calendar years. However, this is not a critical design feature from our perspective and we believe either approach would serve the purpose of the Scheme in an acceptable manner.

3.7 The scheme would have a price cap for the period 2010–11 to 2014–15.

The price cap would be set high enough above the expected permit price to ensure a very low probability of use. The precise level would be set taking into account all information about scheme design and the expected abatement costs in the economy.

The price cap would be reviewed at the first review point, taking into consideration banking and borrowing arrangements, limits on the surrender of international permits for compliance, the maturity of the market and future international linking commitments.

AFMA supports a non-compliance penalty in the form of a dollar penalty plus make-good requirement as this would encourage compliance. However, we are comforted by the Green Paper proposition that the cap will be “... set high enough ... to ensure a very low probability of use” which is effectively an uncapped market, with the Government setting targets such that the likely price range is within its desired range.

It is important that reviews of the price cap should avoid any step-change in pricing. Therefore, decisions about change should be included under the “rolling five year” notice principle, which would prevent uncertainty about the regulation of the market that otherwise could potentially impair its operation.

Feedback on whether the scheme regulator should publish the following information that would assist in the development of the permit market [p.145]:

- quantities and prices of carbon pollution permits auctioned by the regulator;
- the quantity of free carbon pollution permits received by each entity and/or by industry sector;
- total shortfalls in permits surrendered by liable entities; and
- extent and nature of non-compliance with the scheme.

The market will benefit from timely disclosures of supply (ie permits issued and intended to be issued) and demand (ie actual emissions). Disaggregation of both supply and demand by sector will enable more accurate forecasting through better understanding of sectoral trends, calibration of forecasting models to actuals etc. There is no need for disaggregation to the entity level,
and protection of an entity’s confidential/identifiable data should be no less than is currently provided under the National Greenhouse Gas Inventory.

In summary:

1) Volume/price at auction – publish
2) Volume of free allocation by entity and sector – publish by sector, not necessary to do so for entity
3) Shortfalls in surrender by entities – not necessary
4) Extent/nature of scheme non-compliance – publish in terms of total emissions and total surrenders by vintage and sector

AFMA recognises that relevant market information might be provided by emitters on occasion to meet other regulatory obligations (eg ASX continuous disclosure obligations).

As a general statement, the Government should look to “continuous disclosure” by making public the information it has available or has collected/aggregated, as soon as practicable. This applies to the information as above and also to ongoing forecasting as to how Australia is tracking to Kyoto requirements and the consequent outlook for the economy, given the impact on sectoral emissions.

**4.4 Emissions Targets and Scheme Caps**

4.1 At the end of 2008, in the context of the white paper, the Government would announce a medium-term national target range for 2020 that provides upper and lower bounds to give investors and market participants information on directions and retains sufficient flexibility for the Government.

4.2 The Government would announce an indicative national emissions trajectory to provide broad guidance on the pathway towards the medium-term target range.

4.3 The Government would announce a minimum of five years of the indicative national emissions trajectory, to be extended by one year, every year as required to maintain a minimum of five years of guidance at all times after commencement of the scheme.

AFMA supports a minimum rolling five year indicative trajectory concept, as it provides the certainty needed for informed investment decisions. That said, a ten year period is preferred, as it would encourage significantly more emissions reduction investments, being more in line with the evaluation/planning/construction cycle of major infrastructure projects.

4.4 The difference between the scheme cap and the national target would be explicitly and transparently reconciled through notional allocation (and retirement) of permits for sources of emissions not covered by the scheme.

AFMA supports the concept that the difference between the national target and scheme cap should be explicitly and transparently reconciled, by the Government notionally allocating and retiring Australian Emissions Units (AEUs) for uncovered sectors.
4.5 Scheme caps would be set and announced for a minimum period of five years in advance at any one time. In the event that Australia’s international commitment period extends beyond five years, scheme caps would be extended to the end of the commitment period.

4.9 The initial length of the gateway would be 10 years beyond the minimum five years of scheme caps.

4.10 Gateways would be extended by five years, every five years, as part of a strategic review of international conditions and Australia’s likely future international commitments.

AFMA supports ten (not five) year firm scheme caps and gateways to ten years beyond the firm caps. Rolling gateways forward every five years accords with our thinking on the level of certainty required by the market.

4.11 The scheme cap would not be adjusted in the event that it is incompatible with internationally negotiated national targets and, if necessary, the Government would make up any shortfall in internationally agreed targets by purchasing international emissions units.

AFMA supports the Government covering any mismatch between international obligations and pre-set scheme obligations (recognising that this would leave the Government exposed to international price movements) and the same treatment should apply to gateways.

4.12 The Government would announce an approach in early 2010 for expanding the cap to accommodate increases in scheme coverage that provided a smooth scheme price path.

4.13 At the end of 2008, in the context of the white paper, the Government would announce the indicative national emissions trajectory for the period 2010–11 to 2012–13, and in 2010 the Government would announce a further two years of the trajectory up to and including 2014–15, or to the end of any international commitment period, whichever is longer.

4.14 At the end of 2008, in the context of the white paper, the Government would announce an approach for setting scheme caps for the period 2010–11 to 2014–15, consistent with the national emissions trajectory.

In early 2010, the Government would announce the finalised scheme caps for the first five years of the scheme (2010–11 to 2014–15) and 10 years of gateways beyond this period.

AFMA supports the earliest possible firm setting of Scheme caps, in any event no later than 15 February 2010 ahead of the possible first auction in March 2010.

4.5 Reporting and Compliance

5.2 In general, entities with operational control over covered facilities or activities would be liable for emissions obligations arising from those facilities or activities under the scheme.

5.3 Emissions estimation methodologies under the scheme would be those available under the National Greenhouse and Energy Reporting System.
5.4 The following sources would have minimum standards for emissions estimation methodologies imposed from the commencement of the scheme:

- electricity sector emissions (as required for the National Greenhouse and Energy Reporting Scheme and the Generator Efficiency Standards program)
- perfluorocarbon emissions (from aluminium production, as is current business practice and used for the National Greenhouse Accounts)
- fugitive emissions from underground coal mines (as currently mandated by state safety regulations for the large majority of mines).

Staged increases in the accuracy of emissions estimates over time would be pursued by imposing increasing minimum standards for estimation methodologies, where this is cost effective for the scheme overall.

5.6 Consistent with adjustments to the scheme trajectory, five years notice would be given before major revisions of emissions estimation methodologies that affect the majority of stakeholders.

AFMA agrees that emissions reporting by liable entities should be centralised and as simple as possible. This will minimise the compliance burden on reporting entities, reduce compliance risk and promote accurate reporting of data.

5.9 A single report would be sufficient to satisfy an entity’s obligations under both the National Greenhouse and Energy Reporting System and the Carbon Pollution Reduction Scheme, with reports to be submitted by 31 October each year.

Emissions obligations under the scheme, the types of assessment methodologies used and any uncertainty estimates reported by liable entities would be published by the Government on the internet as soon as is feasible after reports are submitted.

5.10 Large emitters (those with obligations under the scheme of 125,000 tonnes of carbon dioxide equivalent or more) would be required to have their annual emissions reports assured by an independent accredited third party prior to their submission. The Government would consider the need to extend this requirement on the basis of initial experience, developments relating to international linking and the compliance burdens likely to be placed on small entities.

AFMA recommends that reported emissions data is released to the market as frequently as possible; in any event at least quarterly. The market needs regular data to progressively adjust market prices to fundamental information and to avoid the sudden and extreme price adjustments seen in the EU ETS which were largely attributed to annual-only data releases. Whilst unaudited data is an acceptable balance between information value/timeliness and compliance costs, any such unaudited data should be subjected to variance/sanity checks when received. Revisions to prior period data should be transparently reported.

An alternative, but definitely second-best, approach is for the Australian Bureau of Statistics (ABS) to establish and report an emissions series as it does for GDP, CPI, employment and other key economic data. An ABS survey
approach may more readily reconcile information value and timeliness with cost.

4.6 Linking the Scheme to International Markets

6.1 The scheme would be designed so that it can link with international markets and schemes, with a preference for open trade within an effective global emissions constraint.

6.2 A carbon pollution permit (which would be referred to in the legislation as an Australian emissions unit) would be created for the scheme, and it would be distinct from Australia’s international (Kyoto Protocol) units.

6.4 Liable entities would be able to meet their obligations by using eligible Kyoto units for compliance in the scheme, limited to a maximum percentage of each entity’s obligation (for the period 2010–11 to 2012–13).

6.5 No assigned amount units would be accepted for compliance in the scheme (for the period 2010–11 to 2012–13). This position would be reviewed in the light of international developments.

6.6 Emission reduction units created under the Kyoto Protocol’s joint implementation mechanism would be recognised for compliance purposes in the scheme (for the period 2010–11 to 2012–13).

6.7 Removal units would be recognised for compliance purposes in the scheme (for the period 2010–11 to 2012–13).

6.8 Certified emission reductions generated by the Kyoto Protocol clean development mechanism would be accepted (for the period 2010–11 to 2012–13), with the exception of those that have associated contingent obligations and high administrative costs: currently, temporary certified emission reductions and long-term certified emission reductions from forestry-based projects.

6.9 Certified emission reductions and emission reduction units generated in the first Kyoto Protocol commitment period would be recognised for compliance in the scheme in 2012–13 and in subsequent years, in accordance with the rules set out in the protocol and any restrictions that apply to the use of international units set out in the Australian scheme.

Certified emission reductions generated through abatement from 2013 onwards by projects established in the first commitment period would be recognised for compliance in the scheme in 2012–13 and subsequent years, in accordance with the rules set out in the protocol and subject to any restrictions that apply to the use of international units set out in the Australian scheme.

AFMA supports linkage to comparable international schemes as an aspirational aim, as it will ultimately create a broader and deeper market. However, given the expected size, breadth and depth of the CPRS as a stand-alone market, there would be sufficient domestic liquidity such that “accessing offshore liquidity” does not make such linkages an imperative.

AFMA supports an introductory period in which there is no ongoing uncertainty around linking negotiations and thus a moratorium on actual linking with carbon markets in other jurisdictions (as distinct from Kyoto Credits which should be recognised from the outset) for five years.
Hence, overall, AFMA supports the linkage stance in the Green Paper.

AFMA supports any unit import limits as expressed as a percentage of each liable entity’s compliance obligation.

AFMA supports all unit type imports.

6.10 International non-Kyoto units would not be accepted for compliance in the scheme. This position would be reviewed for the post-2012–13 period in the light of future developments in international negotiations.

The market can accommodate non-Kyoto units, so AFMA could support acceptance of a small proportion of non-Kyoto units to preserve linkage options, although we are quite happy to see them excluded.

6.11 Australian permits cannot be converted into Kyoto units for sale in and transfer to international markets in the early years of the scheme.

AFMA supports export of AEUs, recognising that there may be a case for short term restrictions to minimise implementation risk.

6.12 Australia would not host joint implementation projects in sectors that are covered by the scheme.

AFMA supports Australia-based JI. If the Government does not wish to create an offset governance regime, then projects to pursue JI Track 2 (ie under UN governance) might be allowed.

6.13 Set unit type eligibility, quantitative import limits and export rules 5 years in advance and roll forward year-by-year.

AFMA supports rules certainty over import/export being set for five years, then extended year-by-year.

Beyond that, AFMA recommends promptly extending rule certainty to the end of any new Kyoto agreement and the use of gateways at +5 years and +10 years applicable to percentage limits on the use of imported units.

6.14 Linking arrangements would be subject to review in the light of ongoing international negotiations and market development, with a clear preference for relaxing restrictions on linking with credible schemes and mechanisms as the Australian scheme matures.

Changes to linkage rules should also be subject to the “five year rolling rule”.

4.7 Auctioning of Australian Carbon Pollution Permits

7.1 Allocations would, over the longer term, progressively move towards 100 per cent auctioning as the scheme matures, subject to the provision of transitional assistance for emissions intensive trade-exposed industries and strongly affected industries.

AFMA supports, over the longer term, moving to 100 per cent auctioning.
7.3 Four auctions would be held each financial year, one in each quarter. The Government seeks stakeholder feedback on the relative risks of alternative models, such as annual or weekly auctions.

AFMA supports quarterly, or more frequent, auctions of similar quantities.

AFMA recognises that with a higher volume of permits in the early stages of the Scheme, there is an argument that quarterly auctions would involve excessive amounts at each auction and a proposal to hold more frequent auctions in the start-up phase should be considered. This would also have the by-product of participants becoming familiar with bidding techniques more quickly (this being more important if the less familiar ascending clock format is adopted) and would ease cash flow pressures *vis a vis* quarterly settlements.

On balance, AFMA favours monthly auctions (at least in the early stages).

7.4 At least one auction of the relevant year’s vintage would be held after the end of the financial year in the lead-up to the relevant surrender date. A suggested date would be within one month prior to the acquittal date.

AFMA recognises that holding one auction post-reporting/pre-compliance adds an extra element of flexibility to end-year liability management, but on balance believes that withholding a sizeable percentage of AEU issuance significantly impairs the ability of entities to take the prudent/conservative risk management approach of matching AEU holdings to liabilities as soon as, or even ahead of, those liabilities arising.

7.5 The first auction would take place as early as is feasible in 2010, prior to the start of the scheme.

AFMA agrees with this timing.

7.6 Four years of vintages would be auctioned (current vintage plus advance auction of three future vintages).

AFMA supports advance auctioning of a percentage of next year’s vintage to create the supply which will enable any “5 per cent shortfall” needs to be satisfied.

Auctions of an additional three vintages also provide an efficient price discovery mechanism which will assist forward market liquidity. This would also promote development of a repurchase agreement (“repo”) market for future vintage permits.

7.7 The advance auction of future year vintages would occur once each year.

7.8 Subject to the lodgement of any required security deposit, universal participation would be permitted at auctions.

Future year vintages should be auctioned more frequently than annually, as auctioning four vintages at the same time is overly complicated. More frequent auctions would also assist smooth development of the OTC forward market.
Consideration might be given to auctioning only one future year vintage with each current year vintage auction. Consistent with our preference for monthly auctions, if 1/8 of the total vintage is 100 permits for each of years V+1, V+2 and V+3 and is to be auctioned in the current year, then 25 of V+1 would be auctioned in January, 25 of V+2 in February and so on over the year. This would also smooth cash flows (relative to annual auctions) for successful bidders. It would mean that 1/32 of the total allocation for a specific future vintage would be auctioned each time, which may raise concerns that the auction size is too small for efficient price discovery. This can be overcome by doubling the size at auction and conducting them every second month.

7.9 Ascending clock auctions would be used for single vintage auctions, and simultaneous ascending clock auctions would be used for multiple vintage auctions.

Whilst the ascending clock model seems more complex and resource-intensive for bidders than the one-round of sealed bids which may be submitted for multiple volume/price combinations methodology, AFMA nonetheless supports it. A sealed bid “pay-as-bid” approach could lead to inexperienced participants overbidding, especially in the “learning” phase, to their financial detriment.

Clearly understood “tie break” rules will be needed.

AFMA recommends temporary constraints on auction participation (eg no single entity can bid for more than 25 per cent of auction volume) to engender widespread market confidence. It is recognised that there are practical issues to be resolved (eg if a joint venture bids, is that allocated pro rata back to the joint venture partners?).

7.10 Only those entities that receive free permit allocations would be allowed to sell them through double-sided auctions in the early phase of the scheme.

AFMA opposes double-sided auctions, as they introduce unnecessary complexity and will hinder the full development of secondary markets. The benefits (larger auctions, increased secondary market liquidity, discouraging hoarding) and the features (low-risk, low-cost, transparent) are not demonstrable.

The Green Paper recognises that opening a double-sided auction to all market participants would crowd out on-exchange and OTC markets. This is true to the extent that any additional supply is made available through the auction process. There will be sufficient liquidity and transparency in secondary markets (even in the early stages of the Scheme) to facilitate efficient sale of permits acquired through free allocation.

On-exchange and OTC markets allow a seller discretion as to whether to deal at a particular bid price. Assuming the free allocation permits are simply added to the auction total, sellers would commit, some time in advance of the auction, to receiving the market clearing price, which is not known until the permits are sold.
4.8 Assistance for Emissions-Intensive Trade Exposed Industries

9.1 The key rationales for providing assistance to emissions-intensive trade-exposed (EITE) industries would be to:

- address some of the competitiveness impacts of the scheme on EITE industries in order to reduce carbon leakage
- provide transitional support to EITE industries that will be most severely affected by the introduction of a carbon constraint
- support production and investment decisions that would be consistent with a global carbon constraint.

EITE assistance would be adjusted over time to ensure that all parts of the economy contribute to the objective of reducing emissions.

The EITE assistance policy would be reviewed at each five-year scheme review.

AFMA acknowledges the case for EITE assistance. When deciding on the method compensation, the effect on market liquidity should be taken into account.

9.2 The proposed assistance would be provided to emissions-intensive trade-exposed industries in the form of free allocations of carbon pollution permits at the beginning of each compliance period, contingent on production.

On market certainty principles, AFMA supports any free allocations being issued annually in advance with the Government enforcing true-ups against actual production on an annual basis.

9.6 Up to around 30% of permits would be freely allocated, 20% excluding agriculture, with eligibility based on industry-wide emission intensity of an activity being > 1,500 tonnes per $1m revenue; Initially, 60% free if > 1,500 rising to 90% free if > 2,000; thresholds and % may be reconsidered to ensure that total assistance limited to around 30% of total permits.

AFMA considers that free allocation to 20 per cent (30 per cent with Agriculture) would not unduly impacting market liquidity.

4.9 Assistance for Strongly Affected Industries

AFMA acknowledges the case for assistance for stranded assets; in deciding the method of compensation, the effect on market liquidity should be taken into account.

4.10 Tax and Accounting Issues

11.1 Discrete provisions of the income tax law would be developed. Such provisions would provide generally the same tax treatment to permits purchased by taxpayers who are carrying on a business or other income-earning activity as would occur under existing legislation, but would provide increased certainty and reduced complexity.

The provisions would allow a deduction for expenditure incurred on the purchase of a permit and include any proceeds from the sale of a permit in assessable income.

11.2 The cost of acquiring a permit would be deductible at the time the permit
is acquired.

If the permit is banked, the effect of the deduction would be deferred until the time the permit is surrendered or sold.

Any proceeds received on the sale of a permit would be treated as assessable income.

11.6 Scheme transactions would be treated under the normal GST rules.

AFMA agrees with the key considerations outlined in the Green Paper (11.1):

1) The tax rules must not compromise the main objective of the Scheme; and
2) The tax treatment should be based on simplicity, efficiency and equity.

Taxation has the potential to adversely affect transaction costs, both directly and indirectly. Poorly designed and executed tax rules for eligible permit transactions could inhibit trading, hinder development of a liquid market and increase the cost of abatement for business and the wider community. With this in mind, AFMA makes the following recommendations in respect of the tax treatment of eligible permits:

**Income Tax**
- Proceed with the proposal to introduce specific provisions for the income tax treatment of eligible permits.
- Eligible permits should be included as a financial arrangement in the forthcoming Taxation of Financial Arrangements (TOFA) regime.
- Entities that would otherwise not be required by law to apply TOFA rules to their business affairs should not be required to do so because of their participation in the CPRS market.
- CPRS penalties should be tax deductible.
- The offshore banking (OB) unit regime should include trading in eligible permits as an eligible OB activity.

**GST**
- Eligible permit transactions in the spot and derivatives markets should be treated as GST-free.

**State Taxes**
- Confirmation should be provided that State governments will not impose a transactions tax on eligible permit transactions.

**Annex 2** provides a more detailed explanation of these recommendations.

### 4.11 Transitional Issues

12.2 State and territory governments are encouraged to discontinue their market-based programs once the Carbon Pollution Reduction Scheme commences. The Government will continue to work cooperatively with the New South Wales, Australian Capital Territory and Queensland governments to assist them in their development of appropriate transitional arrangements.

AFMA restates its position as submitted to the NSW Government that “cessation of schemes is a matter for the jurisdictions concerned” (p.246)
and, further that any concessionary treatment determined by the Commonwealth is ipso facto to the detriment of other Scheme participants.

A key benefit to industry and consumers in the equitable absorption of state-based schemes into the CPRS is the reduction in administration and compliance costs and removal of resource allocation distortions which arise from disparate state-based schemes.

12.3 A program for allocating early action credits would not be established.

AFMA supports not having a specific early action credits program but reiterates that, if the Government does not wish to create an offset governance regime, then it should allow projects to pursue JI Track 2 (ie under UN governance).

4.12 Governance Arrangements and Implementation

The proposed governance arrangements for the Scheme Regulator are in harmony with the governance principles set out in the Department of Finance and Administration’s “Governance arrangements for Australian Government Bodies” and are consistent with arrangements for financial sector regulators. In line with these principles, the statutory framework should be clear on the scope of operational independence for the Scheme Regulator. The scope of operational independence needs to be such that within the Government’s policy goals the Scheme Regulator can effectively administer the Scheme in a way which provides certainty and predictability.

The proposed governance framework is consistent with the Government’s prerogative, subject to Parliamentary oversight, to set public policy for the Scheme and make necessary revisions through transparent formal review processes working within the statutory framework. Commitment to this approach will promote confidence that the market will not be unsettled and undermined by ad hoc policy changes. Similarly, it is important that the statutory framework provides that policy changes are made in a timely way or that default arrangements exist to allow the market to continue to operate in the event that key policy decisions are delayed.

Confidence in the certainty and predictability of the administration of the Scheme are promoted by legislation clearly setting out factors that should be taken into account in decision making processes provided for under the legislation. To the greatest extent possible the Scheme Regulator through its commission structure should handle decision-making for matters which affect supply and demand of permits in the tradeable market guided by statutory rules.

The whole statutory framework should be settled well before implementation of the Scheme. This includes subordinate legislation including any delegated rule-making by the Scheme Regulator, which should be subject to adequate consultation in line with the Government’s policy on Best Practice Regulation. The whole body of legislation should provide a logical, consistent and coherent flow through from clear principles set out in the Act, to sufficiently detailed regulations to provide elaboration and certainty, then to rules prepared by the Scheme Regulator to deal with practical, operational issues.
AFMA appreciates the opportunity to comment on the Green Paper and would be happy to discuss any of the issues raised in this submission or to consider any other matters that you may wish to discuss with us. If we can be of further assistance, please contact Allen Young, Senior Policy Executive, on (02) 9776 7941 or ayoung@afma.com.au and he will make the necessary arrangements.
Annex 1 – Market Integrity Regulation

AFMA supports the Government’s policy of ensuring the efficiency and market integrity of transactions in permits. AFMA also supports the Government’s view that market manipulation and market misconduct in relation to transactions in permits should be prohibited. AFMA believes that these principles are fundamental to the creation of an orderly and efficient market.

However, permits will not fall within the existing definition of ‘financial product’ of the Corporations Act and AFMA does not believe that it is necessary to make permits a financial product under the Corporations Act in order to achieve these policy objectives.1

This is because:

1) As permits are issued by the Government, there is no need to characterise permits as financial products to ensure a reputable and reliable financial instrument;

2) As the rules governing the operation of the auctions are set by the Government, permits do not need to be financial products in order for the Government to be able to regulate the auctioning process;

3) Most other transactions in permits will be forward contracts, or other contracts which will fall within the expansive definition of “derivatives” in the Corporations Act. Derivatives are financial products, and financial services and markets connected with them are regulated by ASIC under Chapter 7 of the Corporations Act and the market misconduct provisions of the ASIC Act 2001. Hence, the existing regulatory infrastructure addresses the regulation of financial markets, market misconduct and financial advice in respect of derivatives;

4) Any transactions that are neither derivatives nor transactions conducted as part of the auctions would not be unregulated just because permits are not financial products. The conduct provisions of the Trade Practices Act would continue to apply;

5) The quality of emissions trading markets is dependent on the amount, quality and timing of information available about emission quantities and allowances. Much of this information will be sourced from the Scheme Regulator. Accordingly, the independent Scheme Regulator will necessarily pay an important role in promoting market integrity;

6) There should be no information asymmetry on the supply side of the Scheme market, as the Government will ensure adequate transparency for Scheme caps and trajectories over time. In contrast, information asymmetry in markets for traditional instruments, like shares and debentures, is significant and requires disclosure regulation (e.g. prospectus requirements) to ensure investors are properly informed.

The approach of not specifying permits as a financial product is consistent with that which has been taken by the Government with other environmental products in the Australian market, with which permits have more in common than with shares or debentures. In particular, there is little expectation that

1 The closest analogy for a primary market in permits is commodities trading. Primary trading in commodities is not regulated as a financial service in Australia because commodities, such as oil and gas, are not financial products.
permits will be traded by retail clients and on that basis there does not appear to be a need to single out permits for "special" treatment in the envisaged manner.

International Experience

The Financial Services Authority (FSA) in the UK has observed that the key differences in the emissions market, compared with other commodities markets, are that it is a politically-generated and managed market and that the underlying is a dematerialised allowance certificate, as opposed to a physical commodity. Also, there is a compliance aspect to the underlying market. The FSA came to the view that these factors do not significantly distinguish the market from other commodities markets or necessitate a widely differing approach from the FSA to this particular market. The FSA also observed that it does not believe the emissions trading markets are any more susceptible to potential market abuse than many other commodities markets.\(^2\)

The FSA does not regulate spot trading of emission market allowances. EU emissions allowances are not specified investments in the FSMA (Regulated Activities) Order 2001, SI 2001/544. Nor is trading in EU emissions allowances specified as a regulated activity in this order. For these reasons EU emissions allowances themselves and spot trading in them is not required to be authorised by the FSA in the UK. However, participants may need to be authorised to enter into derivatives transactions in EU emissions allowances.

Accordingly, the UK approach would be consistent with Australia not including permits as financial products themselves, but regulating derivatives in them in accordance with the Corporations Act.

The New Zealand Government agreed in October 2007 to technical amendments to the Securities Act 1978 and Securities Markets Act 1988 to clarify the regulatory treatment of emissions units and, in particular, to provide that an emissions unit is not a security. The associated discussion paper advised that the reason is so that trading in emissions units does not attract the provisions of the purpose of the above Acts (eg prospectus, insider trading, market manipulation).

This approach would also be consistent with Australia not including permits as financial products themselves, but regulating derivatives in them in accordance with the Corporations Act.

Compliance Costs

The reason for our concern is that there are some significant issues created if permits are specified as a financial product:

1) It is likely to result in considerable implementation costs to Scheme participants, as they are likely to need a variation to their existing Australian financial services licence even if they are already authorised to trade in derivatives. It would also be likely to give rise to significant additional regulatory cost for ASIC, as new processes and procedures would need to be developed to address the new financial product and

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regulatory relief would have to be developed across a range of areas to provide a satisfactory regulatory outcome.

2) It may create a barrier to international trade as current exemptions in relation to the participation of internationally regulated bodies are currently limited to particular types of financial products, which would not include permits. This may affect international linking opportunities with other schemes.

3) A thorough review of the provisions of the Corporations Act would be required to determine if there are any unexpected and unwanted effects - for example those related to disclosure requirements associated with the issue of financial products.

A More Efficient Approach to Regulation

We do not believe additional regulation is necessary, however, should such regulation be contemplated then it should be limited to that needed to achieve the specific objectives sought. For example, if the Government feels that it is necessary to ensure that the provisions of Part 7.10 of the Corporations Act relating to market misconduct apply to transactions in permits (whether or not those transactions are already included in the coverage of those provisions as derivatives), we suggest that permits be included as financial products for that part of the Act only. This would provide the additional regulation of the market required by the Government in a better targeted manner without introducing a new and unnecessary licensing burden. This approach would also be consistent with the Government’s desire to minimise the cost to business arising from the Scheme and with its wider policy objective to reduce the overall regulatory burden on business.

However, AFMA’s view is that even this additional regulation is not required as the derivatives involving permits are already comprehensively covered by the existing law.

We also note that the development of a new market integrity regulatory regime specifically for the Scheme market is not a viable option, as it would generate significant costs and potential regulatory overlap.

There are also a number of practical issues that warrant further attention as the regulatory framework for the Scheme is further developed. For instance, careful consideration needs to be given to how the proposed independent Scheme Regulator will interact with existing financial services regulation. In particular, the Scheme Regulator and ASIC should operate cooperatively to ensure market integrity bringing their complementary skills together to best advantage.

AFMA believes that the industry can make a positive contribution to the further development of the regulatory framework and would welcome the opportunity to participate in associated discussions at the appropriate time.
Annex 2 – Taxation Issues

1. Introduction

AFMA agrees with the key considerations outlined in the Green Paper (11.1):

1) The tax rules must not compromise the main objective of the Scheme;
2) The tax treatment should be based on simplicity, efficiency and equity.

These are important because the design of effective tax rules to govern transactions arising from the Scheme is essential to the success of the Scheme. Poorly designed and executed tax rules for eligible permit transactions could inhibit trading, hinder development of a liquid market and increase the cost of abatement for business and the wider community.

It is worth recapping the critical features of the Scheme that the proposed taxation rules must apply to and complement to meet its objectives.

A cap and trade approach is being taken to deliver abatement under the Scheme, so the ‘market’ for trading eligible permits and rights in respect of them is the linchpin of the Scheme. The market facilitates price discovery, permit exchange, allocation efficiency and it is where risk transfer occurs.

✧ The key objective for the design of tax rules to complement the Scheme must be to support an efficient permit market.

The market will encompass spot trading in permits and trading of derivatives that embody rights in respect of permits. In practice, the great majority of permit trading will take place in the derivatives markets, both on-exchange and OTC. The primary participants in the market will be emitters who have a liability under the Scheme; entities with an economic exposure to the Scheme; and brokers and financial intermediaries who will facilitate trading, finance and risk management. There will be an international dimension to the market and, subject to restrictions CERs, ERUs and RMUs will be accepted for compliance purposes in the early years of the Scheme.

✧ The tax system must accommodate the needs of each market participant in an efficient manner and facilitate the international dimension of the market, if the Scheme objectives are to be met.

Liquidity is an essential attribute of an efficient market and it depends on a range of factors including transaction costs that reflect government taxes, spreads and the price impact of transactions.

✧ Taxation has the potential to adversely affect market liquidity.

In summary, it is vital for the tax rules to apply to Scheme transactions in a manner that does not inhibit the operation of the market in bringing about the objectives of the Scheme. To achieve this, the analysis that underpins the tax policy adopted should take full account of:

* The nature of the market (in particular the key role of derivatives trading, which is not really dealt with in the analysis in Chapter 11);
• The range of transactions (spot and various types of derivatives involving permits and recognised Kyoto units); and
• The variety of participants in the market (emitters, intermediaries etc).

Moreover, the income tax and GST rules that are put in place at the outset of the Scheme should be designed with the long run development of the market in mind, taking account of expected future developments including the increasing sophistication of derivatives products and greater international integration of markets as the markets here and overseas mature.

2. Income Tax Issues

2.1 A Separate Code

The introduction of a Scheme will generate a number of complex tax issues that are not adequately dealt with under the current tax law. Hence, AFMA agrees that to provide a certain, efficient and fair outcome in a timely and assured manner, it is appropriate to create a separate tax code for the taxation of Scheme transactions.

That said we also believe that the desired tax outcome will hinge in some instances on the interaction of the proposed code with other parts of the tax law. In particular, we recommend that taxpayers who are to be within the proposed taxation of financial arrangements (TOFA) regime will use those rules rather than the separate Scheme code.

Recommendation – Proceed with the proposal to introduce specific provisions for the income tax treatment of eligible permits.

2.2 Taxation of Financial Arrangements (TOFA)

Financial institutions will play an important role as intermediaries in the operation of the Scheme market, so the Scheme tax code must interact effectively with the planned TOFA regime (which is due to be introduced into Parliament later this year). In particular, the entities to which TOFA will apply should be able to have their transactions in eligible permits treated as a financial arrangement under TOFA.

Companies who would otherwise not be required by law to apply TOFA rules, or would not ordinarily seek to apply the TOFA rules to their business affairs, should not be required to do so because of their mandated participation in the Scheme. This approach will minimise compliance costs for these entities.

Financial institutions will provide market liquidity by offering a range of trading, broking and risk management services to entities that have an exposure to the Scheme. In this context, the range of transactions will be comparable to other financial markets, covering spot trades, forwards and options (on-exchange and OTC), structured products, permit lending arrangements and repurchase agreements, amongst other things. Typically, they will mark-to-market their positions and operate their trading book on a hedged basis to contain their risk.

We expect that the great majority of market transactions will take place in the derivatives market and, thus, they should fall outside the Scheme tax code and should be treated as a regular financial arrangement under TOFA.
Examples of likely transactions in the near term include:

- Selling a permit forward to an emitter who wants to cover a future obligation to surrender a permit, without having to outlay the associated cash expenditure at this point in time;
- Writing a call option for an emitter who wishes to limit the potential cost of Scheme compliance at a specified level;
- Selling spot permits to market participants as a market maker, on occasion using borrowed permits to make delivery on settlement.

The management of risk associated with these services requires an intermediary to be a regular participant in the spot and derivatives markets, borrowing permits to meet delivery obligations, lending permits to minimise net holding costs etc. In other words, it is anticipated that banks and other financial intermediaries who participate in the Scheme market will transact in much the same way as they do in other markets.

While the proposed Rolling Balance method (suitably modified to reflect comments made by corporate representatives during consultations) may in principle be adequate for many participants, it is too basic to serve as a model for taxing intermediaries in the market. The most practical solution is to allow financial institutions to treat eligible permit transactions as a financial arrangement for TOFA purposes. This would automatically recognise mark-to-market valuation of trading positions and the hedging of Scheme transactions within a trading book, within a consistent and tested framework.

One of the key objectives of TOFA is to minimise taxpayer compliance costs and the exclusion of one part of a financial intermediary’s trading book from TOFA would clearly conflict with this objective. The proposed TOFA provisions provide a ready mechanism to bring Scheme eligible permit transactions within the scope of TOFA for dealers. In particular, the proposed TOFA treatment of commodities dealers provides a purpose and rationale, as well as the design of a provision, for the inclusion of eligible permits within the TOFA regime.  

Recommendations –

- Eligible permits should be included as a financial arrangement in the forthcoming taxation of financial arrangements regime.
- Entities that would otherwise not be required by law to apply TOFA rules, or who would not ordinarily seek to apply TOFA rules, to their business affairs should not be required to do so because of their participation in the Scheme market.

2.3 Penalty

As outlined in Section 4.3 in the body of the submission, AFMA believes that Scheme penalties should be tax deductible.

Recommendation: Scheme penalties should be tax deductible.

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2.4 Offshore Banking (OB) Transactions

The Government has reinvigorated the policy commitment to further develop Australia as an international financial services centre. AFMA’s member firms have sought over the years to maximise the proportion of their international business activities conducted in Australia.

Given Australia’s leadership role in carbon abatement within the region, there is potential for Australia to serve as an international centre for the trading of carbon instruments and for the provision of related services. Under the right conditions, there is an opportunity to capture a significant share of the regional market for carbon-related activities.

Australia will evidently face competition for this business from other centres in the region (including Hong Kong and Singapore), so we need to ensure that our competitive strengths are supported by appropriate tax rules. Against this backdrop, an obvious initiative would be to include Scheme permits (and Kyoto units) as OBU eligible transactions. The policy underpinning the OBU regime would support this approach, which would merely require an updating of the regime to reflect a market development in the form of a new market.

Recommendation – The OBU regime should include trading in eligible permits as an eligible OB activity.

2.5 Further Analysis of Potential Tax Treatments

AFMA’s primary focus in responding to the Green Paper is to ensure that the associated tax, regulatory and Scheme administration rules promote a liquid and efficient Scheme market. Alternative Scheme tax measures may be considered by the Government in light of the Green Paper consultation process. We wish to emphasise the need to assess all tax code measures under consideration by reference to their contribution (positive or negative) to the development of an effective market. For example, a tax rule that creates a disincentive to trading on the market would harm market liquidity and, thus, should be avoided.

With this in mind, AFMA encourages the Government to continue to consult widely on potential tax changes before final decisions are made on the tax treatment of Scheme transactions. In this regard, we note that consultation to date on Scheme taxation issues has been well-managed and effective.

3. GST Treatment of Scheme Transactions

The GST design issues associated with the Scheme boils down to one simple proposition; if the Government’s intention is to avoid imposing a GST burden on business as a consequence of the Scheme, then Scheme transactions must be treated as GST-free, as all of the alternatives imposes a cost on business. We now explain why this is the case.

Policy Framework

GST-free treatment is the only approach that is entirely consistent with the fundamental policy objectives of both the GST and Scheme. The GST is a consumer tax that should not create tax cascading and should not impose a tax liability on business. GST-free treatment would meet this objective and
this alone is sufficient reason to adopt it. The Scheme market will substantially be a business-to-business market, so GST-free treatment would not affect tax revenue (other than the cash flow issue discussed below). This approach would also align with the Government’s policy to minimise the cost burden that official regulation places on Australian businesses.

GST-free treatment would also address the key tax considerations outlined in the Green Paper. In particular, the GST rules and their administration would be simple and efficient to comply with (easing the burden for both taxpayers and the ATO), it would be tax neutral across traded products and the tax outcome would be equitable.

**GST Cost Imposition on Business**

AFMA believes the Scheme should not give rise to additional taxation of business and, in particular, we agree with the proposition that there should be no additional GST burden. In this context, we are concerned that the preferred position for the GST treatment of transactions under the Scheme, outlined in the Green Paper (11.8), would impose a cost on business.

The proposed GST treatment of eligible permit transactions would give rise to complexity given the range of possible tax outcomes for trading in eligible permits and associated derivatives. Spot trading would be treated as a taxable supply, some derivatives would be taxable (eg a futures contracts settled by delivery) and others input taxed (eg cash settled derivatives contracts), auctioned permits would be taxable, free permits would attract no GST and eligible imports may or may not attract GST.

Business would incur a GST cost through higher tax compliance costs and input taxation, giving rise to non-recoverable GST in some circumstances:

- **Tax compliance costs** –
  Registered entities must satisfy GST administrative obligations, adjust systems to track transactions receiving different tax treatment and recover GST paid on inputs that are used for a creditable purpose.
  Intermediaries and active traders would face specific implementation costs. Dealing systems are typically designed to trade input taxed securities and do not have capacity to produce tax invoices, while standard deal confirmations will not serve as a tax invoice. In addition, the GST would create risk management complications, as the GST component of the permit price would have to be separated to enable effective management of credit risk and market risk and to ensure efficient utilisation of business capital.
  Emitters and traders who purchase and hold permits will have to meet the cost of working capital to cover timing differences between the payment of GST on permit purchases and recovery in the following tax period. Having regard to these factors, GST compliance costs for both emitters and other market participants will be considerable.

- **Input taxation** –
  The bulk of Scheme related carbon trading will take place through the derivatives market. Derivatives that entail the delivery of a permit will be taxable but derivatives that involve no option, right or obligation to
deliver are input taxed. AFMA expects an active market to emerge in respect of both deliverable and cash settled derivatives contracts over time.\textsuperscript{4} The application of normal GST rules will impose a non-recoverable tax on cash-settled business through input taxation, which will increase the cost of market transactions and would seem contrary to the Government’s objective of not imposing a Scheme related tax burden on business.

Trading in financial instruments (shares, bonds etc) is input taxed, so the input taxation of associated derivatives transactions gives an internally consistent outcome within the GST framework. This is in contrast to the proposed treatment of eligible permits, which has less congruency of treatment across the range of likely transactions. This variability of treatment was encountered with the taxation of precious metal supplies (like gold bullion) when the GST rules were being developed. It was resolved in that case by input taxing spot and derivative transactions in precious metals.\textsuperscript{5} However, this option is not open for eligible permits, as input taxation of all transactions would impose a considerable GST cost on business affected by the Scheme, which is contrary to government policy.

Having regard to the various issues, especially the desire to minimise tax compliance and input taxation costs, AFMA recommends that eligible spot and derivatives transactions should be treated as GST-free by applying Division 38 of the GST Act to them. The GST Act provides for different tax treatments for a range of similar transactions and contains mechanisms to contain any potential revenue risk this might create (eg rules deal with mixed supplies).

This approach is supported by other relevant factors. For instance, the GST-free treatment would make it less confusing for international participants who wish to enter the Australian market, as they would not need to rely on the GST-free export provisions. This would also remove the need to confirm that an international purchaser is not present in Australia to ensure the GST-free export provisions are met. This outcome is consistent with the objectives of the Scheme, as greater international participation would increase liquidity in the market. In addition, offset projects (such as forestry schemes) might be seen as having a connection with real property in Australia, thereby preventing the operation of s.38-190, item 2, so their sale could be subject to GST even if sold to non-residents.

Finally, we note New Zealand’s GST treatment of its carbon offset scheme. The initial government position in 2007 was that trade in New Zealand Units (NZUs) under the scheme would be a service subject to GST and taxable under normal GST provisions. However, following industry submissions, NZUs and Kyoto units will be treated as zero-rated (equivalent to GST-free treatment under the Australian GST Act) to ensure GST has a neutral impact and does not hinder the acquisition and disposal of emission units across international markets. The changes will be effective from 1 January 2009.

Recommendation: Eligible permit transactions on the spot and derivatives markets should be treated as GST-free.

\textsuperscript{4} This is consistent with market developments overseas – for example, in 2007 the Chicago Futures Climate exchange launched a cash settled CER futures contract and the first cash settled OTC forward contract in EU allowances was made in 2004.

\textsuperscript{5} Except in the case of the first sale after refinement, by a refiner to an investor, in which case the supply will be GST-free.
4. State Taxes

We are not aware of a definitive statement to the effect that no State taxes will be applied to trading in Scheme eligible permits. While we acknowledge this issue may be outside the scope of the Green Paper, we reiterate our concern about the harm a transaction tax can cause to a financial market by increasing transaction costs and lowering liquidity. Moreover, this would increase the tax cost of an emissions trading scheme on Australian business. We believe that the Government should work with the States to confirm that a transaction tax will not apply to Scheme eligible permits.

Recommendation: Confirmation should be provided that State governments will not impose a transaction tax on eligible permit transactions.

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