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Consultation Support Team
Department of Climate Change and Energy Efficiency
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Dear Consultation Support Team,

The Investor Group on Climate Change Australia/New Zealand ('IGCC') would like to thank you for the opportunity to comment on the carbon price scheme proposed by the Multi-Party Climate Change Committee (MPCCC). This submission addresses the broad architecture of the carbon price scheme to date and touches on important issues that have yet to be agreed upon.

Background

IGCC represents a group of Australian based institutional investors with over $600bn of funds under management – funds invested on behalf of around five million Australians – and other key participants in the investment community. The group includes industry superannuation funds, the large retail and wholesale funds managers, property investment trusts and the research houses of the global investment banks. Members of IGCC invest in all sectors of the economy, emissions-intensive and low-emissions alike, and are part owners of most of Australia's large companies. With our international colleagues, we are part owners of many thousands of listed companies globally.

We accept the science of climate change and consider that prudent management of related investment risks is the only responsible course of action for institutional investors. Despite the short-term pressures of capital markets, ultimately our responsibility is to the long-term interests of our beneficial members.

Members of IGCC have the capacity to reallocate capital to address shifting economic circumstances and emerging investment opportunities over the long-term. Where sudden economic adjustments usually lead to loss of investment value, steady economic transitions allow for reallocation of capital in a staged way, thereby minimising investment loss. We believe that significant economic adjustment will be necessary over the long-term as a result of, and in order to, address climate change. Therefore, IGCC looks to ensure as smooth an economic and investment transition to a low-carbon economy as possible.

Guiding Principles

The obligation to the long-term interests of our members, as well as the fact that we invest across all sectors of the economy, leads us to consider the following points of principle to be important in the development of a carbon pricing framework for Australia. The scheme should:

- Commence early to reduce the overall cost of economic transition;
- Ensure broad sector coverage to share the cost of economic transition and access least cost abatement;
- respond to market forces if it is to be efficient as a market scheme;

- provide relative certainty on framework design and regulatory arrangements going forward;
- contribute to and link with global arrangements to address climate change;
- ensure transitional assistance achieves the outcome of lowering emissions.

To make investment decisions on long-lived assets, investors must assess the likely cost of various factors of production over the operating life of an asset. Assessment of a carbon price over the full asset life is necessary before an investment decision is made.

All market actors rely on assessments of future prices (such as interest rates or commodity prices) when making investment decisions. The greater the uncertainty regarding a forward price curve, the more significantly investors will discount possible future investment returns. If the discount in expected returns is significant enough, investors will simply delay investment decisions, valuing the option to make a later decision more highly. Regulatory uncertainty usually results in significant discounting of expected investment returns and delays investment decisions.

In addition to longer-term concerns, any delay in scheme commencement or clarity delays investment decisions across the economy today. Existing emissions-intensive assets require clear plans for their utilisation and development. These plans cannot be resolved until the timing and extent of carbon price impact can be clarified in investment models.

Institutional investment in large-scale clean technologies and new energy opportunities will also be affected if a price signal is not operating in the market. As investors of the savings of others (in most cases the superannuation savings of Australians) institutional investors will not be in a position to support large-scale, low-emissions technologies and businesses without a clear investment proposition. A price on carbon is a necessary input to this investment proposition.

With the above comments in mind, IGCC submits the following feedback on the proposed carbon price scheme design:

Start Date

IGCC supports the proposed scheme start date of July 1, 2012.

As long-term investors across all sectors of the economy, IGCC members wish to see a steady economic and investment transition to a lower-carbon economy. An early start to emissions trading in Australia, even with a fixed price period, is a key step to mitigate potential volatility in the economic transition in the future.

Transition arrangements

IGCC agrees with the proposition that, with regards to the transition from a fixed to a flexible price, “it would be important to design the arrangements so as to promote business certainty and a smooth transition.” Climate change policies should ensure that rules regarding future carbon costs are clear and predictable and established via stable and enduring market schemes to provide investment certainty and to allow the economy and communities to adjust to a lower carbon future.

IGCC seeks transition arrangements that minimise uncertainty and cost, and maximise time for business preparation and investment decisions. This would allow the formulation of a reliable forward carbon cost curve, which is essential for investment decisions in sectors affected by a carbon price. The keys to achieving this are transition arrangements that are predictable from the start and minimise the risk of regulatory change later.

Changes to policy settings introduce significant risk into investment decisions. Where major elements of carbon policy, such as the date for the transition from a fixed to a floating price, are subject to external review or other political uncertainty, the development of forward carbon price curves will be significantly impaired, negatively affecting investment in low-carbon assets.

Length of Fixed-Price Period

A fixed price period will help market participants accept that a period of abating business emissions has commenced and will drive some behavioural change by companies and investors. While this may be welcome as a short-term influence on investment decisions, a fixed price period also delays market based discovery of the price of abatement in the economy, relative to any future emissions target, and therefore perpetuates some uncertainty about future carbon price arrangements.

Regardless of the progress in development of a post-Kyoto international policy framework, we believe that Australia should move to an emissions trading scheme that allows international permits, as soon as possible after scheme commencement.

<u>We would still prefer an immediate start to emissions trading</u>. Allowing the market to determine the carbon price and import credits, in response to an emissions reduction target when that is set, provides the lowest cost abatement path for the economy and our investments.

Delaying the implementation of a flexible carbon price and related emissions reduction target results in a reduced time period for companies and investors to respond to and achieve a 2020 target. This increases the chance of a more volatile economic and investment transition, especially if the final emissions reduction target differs from the initial fixed price trajectory and results in increased costs to businesses in complying with the scheme. We therefore consider that any fixed-price period should be as brief as possible.

<u>If the proposed 3 – 5 year timeframe for transition to a flexible market price is retained, we strongly favour the 3 year option. Under these arrangements, a decision to set the 2020 target by July 1, 2014 and commence the flexible price phase on July 1, 2015 is supported.</u>

If the timetable for the transition from a fixed to a flexible price is contingent on an external review or subject to any other timing uncertainty, investment decisions are likely to be delayed and domestic abatement efforts undermined. This is because investors will discount likely returns over time if future regulatory arrangements are unclear.

<u>We encourage the Government and the MPCCC to remove the condition for a review of the intention to transfer to a flexible price on the specified date.</u>

Setting a 2020 target any later that July 1, 2014 limits the chance for Australian businesses to plan for emissions abatement activities in a timely way. The consequence of setting a 2020 target late in the decade is that companies will be more likely to purchase emissions abatement rather than undertake costly abatement projects within their businesses in Australia. The practical implications of securing finance, planning, staffing and implementing abatement projects make this so. If importing of international credits is allowable, then this is what companies are likely to do.

IGCC sees potential long-term costs for a smooth economic transition resulting from a fixed price period but believe that this is not sufficient reason to delay the introduction of a carbon price scheme. We strongly advocate that the fixed price period be as brief as possible, with a definite date of transition and no review of the transition date, in order to provide regulatory certainty, reduce risk and encourage long term investment.

Forward price curve

Without a 2020 emissions reductions target in place at scheme commencement, it is important to provide the market with tools to discover future permit prices before the commencement of the flexible price period. The ability to estimate future permit prices will reduce the risk of a volatile price shift in the transition to a flexible price. The tools should:

- Provide a scheme to allow the development of forward price curves by market participants;
- Allow firms to gain experience from participating in an auction-based permit market;
- Increase investor and firm confidence in both the stability and longevity of the scheme;
- Decrease uncertainty, risk and potential market volatility;
- Smooth the transition from a fixed to a floating price.

Auctioning a small portion of undated permits into the scheme from day 1 (Garnaut proposal).

<u>IGCC considers that making a portion of undated permits available for purchase through auction from the start of the fixed-price timeframe would aid price discovery and confidence in the longevity of the carbon price framework</u>. We agree with Professor Garnaut (6th Update Paper) that allowing 5-10% of the annual volume of permits to be purchased via auction would help to increase credibility and reduce uncertainty about future carbon arrangements.

We note that unless potential buyers of undated permits have certainty around options for their submission to meet compliance obligations, there is unlikely to be substantial demand for these permits. If for any reason undated permits could not be submitted for compliance purposes in the fixed price period, the prospect of a review of the date of transition to a flexible price would undermine the utility of the undated permits to the market.

A floor price

As a matter of principle, IGCC does not support constraints or distortions on the operation of the future carbon market in the flexible price phase. The use of price floors and caps are distortions designed to drive certain investment outcomes in the short term and presuppose market conditions and investor decision making in future.

A price floor will delay the time at which the market will determine the price of carbon and therefore only postpones the risk of a volatile price shift. Delaying a price shift by several years makes little substantive difference to financial risks in investment decisions for assets with operational periods of multiple decades.

Introducing a price floor to address a supposed market failure before the market has even started operating would seem to be an excessive, pre-emptive intervention.

The other practical question relating to a price floor is how international permits are treated in the flexible price phase. If the price of international permits is lower than the floor price, importing of permits would either create two prices or would make one or other of the permit types redundant, depending on the scheme rules. A price floor puts the objective of least cost abatement at risk.

Coverage

IGCC agrees that scheme coverage should be as broad as possible. Investors are concerned with the distribution of costs in the economy as well as total cost to the economy from reducing emissions. Broad coverage maximises opportunities for least cost abatement, minimises overall costs to the economy of achieving a national carbon reduction target and distributes costs across the economy more evenly. <u>We do not support the phasing of certain sectors into the scheme at specified or unspecified dates after scheme commencement.</u>

IGCC recognises that some sectors and companies have limited potential to pass emissions costs through, especially if companies operate in international markets where no comparable price on carbon is in place. Trade exposure is not, however, a reason for a sector to be protected from abatement costs faced by the economy as a whole. The higher the levels of compensation provided, the higher the abatement costs transferred to other sectors of the economy.

Any carbon price protection that is enjoyed by one sector of the economy will result in a burden for emissions reductions and therefore a greater price impact elsewhere in the economy and therefore on our other investments. IGCC also believes that it is also generally important to include industries in the scheme to prepare them for a more carbon-competitive future.

<u>We further consider that neither the level of technological development in any given industry (for example in regards to fugitive emissions), nor the potential of any industry to produce substitutes for higher emissions energy sources (LNG) are sufficient arguments for the partial or full exemption of those industries from the scheme</u>.

Considering each of the reasons above, IGCC retains its concerns about the exclusion of any industries and activities from the price scheme.

International Linking

In the interests of achieving least-cost abatement, IGCC supports provisions that allow the purchase of emissions units from the international market, during the flexible price phase of the proposed scheme. By allowing international emissions units to be purchased by domestic companies, the necessary emissions reductions are able to be made at the lowest cost. This helps to minimise the disruption of the domestic economy, while fostering investment of low-carbon solutions in developing economies. IGCC does not favour constraints on importing during the flexible price phase.

As stated, IGCC would strongly prefer that decisions around the time at which importing will be allowed and any limits on quantity are made as soon as practicable, in order to reduce uncertainty, risk and volatility within the market.

We note that Australia would likely be supporting the development of international markets by indicating early the date at which Australia's scheme will link to international schemes.

IGCC is open to the proposal put by others in public debate that limited international linking takes place in the fixed price phase of the scheme. We note however that the prospect of multiple permit prices for different types of permits (*undated, CFI [see below], international and fixed price compliance permits*) adds to the complexity of the scheme for participants.

Assistance and other matters still to be determined

Emissions Intensive Trade Exposed (EITE)

EITE activity assistance should be provided to minimise the likely transfer of existing industry or operations overseas (so called carbon leakage) and provide a degree of long-term certainty on the level of transitional assistance to enable long-term investment, including investment in abatement.

Again, it is important to note that IGCC members hold investments across the economy. Any transitional assistance in one sector pushes increased costs onto other sectors and so increases costs to other investments we hold. Therefore, IGCC members believe:

- EITE assistance should not remove the incentive for industries to reduce their emissions or eliminate emissions intensive activities;
- EITE assistance should be transitional in nature. Provisions should be in place to phase the assistance out over time;
- EITE assistance should only provide protection for certain activities in the event that trading partners do not implement emissions reduction policies that impose a cost on industry. We note that determining precise comparative carbon prices is difficult without an international emissions trading scheme.

We note that setting long term carbon price arrangements based on short to medium term business pressures is not a sound basis for economic policy making. IGCC does not support modifications or carve outs from the carbon price arrangements for example, because of the very real pressures businesses face due to currency variations.

It is important that investors are able to accurately assess the financial impact of the carbon price on their investments, and known activity compensation levels are required to achieve this. IGCC believes that resolving an agreement on the framework and policy design of the carbon price scheme should be the top priority. Certainty with regards to a scheme design and commencement is more important than specific design issues. Minor changes in transitional assistance levels, relative to the CPRS assistance levels, is not of material concern to investors.

Carbon Farming Initiative (CFI)

IGCC supports the purchase of small amounts of CFI permits (credits consistent with Kyoto obligations) during the fixed-price phase of the proposed carbon price scheme. Encouraging investment in this area as soon as possible in order for domestic carbon offsets to be available from the beginning of the flexible-price phase is a useful capacity building step for the market and agricultural sector. However, a limit should be placed on the amount of permits that could be submitted as compliance instruments so as not to undermine budget constraints of the Government in operating the scheme.

Conclusion

Of the matters raised in this submission, investors are most concerned about the prospect of a review of the terms and timing for transition to a flexible price scheme after 3, 4 or 5 years. Despite the stated intent to transition from fixed to flexible pricing after a certain number of years, the prospect of a review that may delay the date of the transition introduces significant uncertainty for investors. We restate our preference that the transition from fixed to flexible pricing no longer be subject to a review by the Parliament.

We are available to discuss transitional arrangements and other maters raised in this submission at your convenience.

Yours faithfully,

Nathan Fabian
Chief Executive
Investor Group on Climate Change