Investor Group on Climate Change

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Professor Ross Garnaut
Garnaut Review Secretariat
Level 2, 1 Treasury Place
East Melbourne VIC 3002

Dear Professor Garnaut

The Investor Group on Climate Change Australia/New Zealand ('IGCC') would like to thank you for the opportunity to provide comment on Issues Paper 2: Financial Services for Managing Risk: Climate Change and Carbon Trading ('the Issues Paper').

Background to the Investor Group on Climate Change

The IGCC represents Australian investors, with total funds under management of over **$425 billion**, and others in the investment community interested in the impact of climate change on investments. The IGCC aims to ensure that the risks and opportunities associated with climate change are incorporated into investment decisions for the ultimate benefit of individual investors through:

- Raising awareness of the potential impacts, both positive and negative, resulting from climate change to the investment industry, corporate, government and community sectors;
- Encouraging best practice approaches to facilitate the inclusion of the impacts of climate change into investment analysis by the investment industry; and
- Providing information to assist the investment industry to understand and incorporate climate change into investment decisions.

More information on the IGCC can be found at www.igcc.org.au.

Introduction

Australian financial markets have a powerful and diverse role to play in facilitating the management of risk and opportunities associated with climate change and carbon trading. The IGCC commend the Garnaut Review for considering the role of the financial markets but highlight that the three issues raised are but a limited set of the many areas in which financial markets will play a role in facilitating the management of risk and opportunities associated with climate change.

Other areas where financial markets, and particularly the investment industry, can play a significant role are:

- Pricing of climate change risk and opportunity in equity markets which will influence corporate behaviour
- Generation of information flows on climate change and greenhouse issues
- Investment in building energy efficiency
- Investment in alternative energy and other emerging technologies
- Assistance in better understanding the investment consequences of now unavoidable impacts of physical climate change and support for adaptation measures

This submission covers the key issues for the investment industry raised in the Issues Paper.

3.2 Building Effective Carbon Trading Markets

As long term investors across all sectors of the economy it is important to investors that an emissions trading scheme is efficient and does not cause distortions in the market (such as imposing costs on some sectors while generating windfall gains to other sectors). It is critical for investors that an emissions trading scheme achieves an efficient market and least cost abatement.

Auctioning

The IGCC concur that the permit allocation approach is likely to result in vastly different impacts on the economy including distributional impacts.

Impact of permit allocation on key Australian sectors

Research undertaken by the IGCC[1] demonstrated that the permit allocation approach resulted in vastly different impacts on different sectors in the economy. For example, full auctioning resulted in an estimated total cost of carbon for the steel sector of $477 million p.a[2], whereas the free allocation of 90% of permits (grand-fathering) reduces the total cost of carbon to an estimated $130 million p.a[3].

The research further demonstrated that using an alternative method for free allocation of permits – output based allocations using an emissions intensity target – the incentive for opportunity cost pricing is largely eliminated. This significantly reduces the impact of carbon pricing (with the entire change attributable to a reduction in indirect exposure from electricity consumption). The total cost of carbon declines to $48 million p.a[4].

These findings were consistent across the construction materials sector as well as the energy and airport infrastructure sectors.

Impact of permit allocation approach on the wealth transfer

The emissions trading scheme proposals outlined by the previous Federal government's Taskgroup on Emissions Trading (TGET) and the State governments' National Emissions Trading Taskforce (NETTs) seek to ultimately establish full auctioning of emissions permits which will lead to a transfer of wealth of the order of $8-10 billion per year (400 million permits at $20-25/tonne CO2-e) to the government. Depending on any compensation, some of this wealth transfer is likely to be shifted to electricity generators and/or some trade exposed industries.

This is the case even though the cost of undertaking emissions abatement may be substantially less (<10%) than the wealth transfer (outlined above) in the first 10 years of the scheme. To explain, given a likely cost of permits is around $25/tonne CO2-e in the early years of the trading scheme and an emissions reduction targets in the order of <10%, or approximately 40 million tonnes, the cost of achieving the emission abatement in the early years will be <$1 billion per year (40 million permits at $25/tonne CO2-e). However, the value of the permits within the trading scheme will be of the order of $10bn (400 million permits at $20-25/tonne CO2-e). Therefore, the allocation of the permits will lead to a significant reallocation of wealth, which only indirectly reflects the cost of achieving the objective of the scheme, i.e. emissions abatement.

This transfer of wealth will be reflected in higher wholesale electricity prices and higher prices for domestic energy/greenhouse gas intensive products, with increases typically ten times that required to meet the cost of emissions abatement. This potential outcome is of significant concern to investors.

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[1] IGCC 2007, *Potential Earnings Impacts from Climate Change for Key Australian Sectors,* www.igcc.org.au.
[2] Assuming a permit price of $25 a tonnes before considering cost pass through or emission reduction action.
[3] Assumptions as above.
[4] Assumptions as above.

Permit price realisation and discovery
Auctioning of some permits is necessary for price realisation and discovery. While the exact number of permits that need to be auctioned to achieve price discovery has not been determined by IGCC and needs to be further researched, it is likely to be only a fraction of the potential total number of permits (400 million) to be auctioned under a full auctioning permit allocation approach.

Therefore, to reduce the cost to the economy and the redistribution of wealth, IGCC recommend that only a that proportion of permits required to achieve price realisation and discovery are auctioned.

Proposed IGCC Research
To support these recommendations the IGCC is currently undertaking research to explore the different impacts emanating from alternative schemes design structures and to highlight, in an accessible way, the impacts of these schemes in terms of emissions, electricity pricing and output. Particular attention will be drawn to the types of economy wide impacts of these schemes.

The study will include modelling of:

- a baseline credit scheme;
- a cap and trade scheme, with full auctioning of permits;
- and a cap and trade scheme implemented through a scheme of output based allocations. For the purpose of this exercise, the allocation rule will be based on an emissions intensity target.

The modelling would cover the NEM, and would extend out to 2030. It would take into account policy commitments relating to renewable targets and energy efficiency.

The IGCC would appreciate the opportunity to present the findings of this research to the Garnaut Review Secretariat on its completion (estimated mid March).

Facilitating Forward Trading Markets – Banking and Borrowing of Permits
The IGCC supports the development of efficient carbon trading markets, that provide long term and credible signals that are supported by adequate regulatory rules. To achieve this, IGCC recognise the importance of developing forward markets to facilitate long term efficient investment decisions and drive emissions reductions.

However, restrictions on the use and trade of permits (such as limits on banking and borrowing of permits) may be necessary to meet emission reduction targets. The IGCC supports restrictions on borrowing of permits to ensure that the underlying aim of the scheme – emissions reduction – is not compromised.

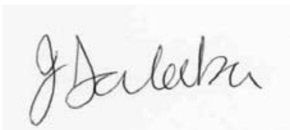
3.3 Positioning Australia as a regional hub in the Asia Pacific carbon markets
The IGCC supports the positioning of Australia as a regional hub in the Asia Pacific. Despite Australia's delay in ratifying the Kyoto Protocol Australia's financial services sector including many members of the IGCC have developed significant expertise in carbon investment markets and have tapped into numerous business opportunities including helping to facilitate new technologies through project financing.

To facilitate Australia becoming a regional hub in the Asia Pacific carbon markets the Government needs to rapidly develop and implement climate change policy that gives Australia credibility in the region. The Australian government should commit to ambitious absolute greenhouse gas emission reduction targets for the medium and long-term, with credible mechanisms to ensure compliance.

Australia should also take a leading position in the region and work with the international community to develop agreement on the key elements of a post-2012 framework.

The IGCC would be happy to further discuss the issues raised in this submission. Please do not hesitate to contact me on (03) 9018 2215, 0422 101 715 or by email secretariat@igcc.org.au.

Yours sincerely



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