



INTERIM PARTIAL (ONE-WAY) LINK BETWEEN THE AUSTRALIAN EMISSIONS TRADING SCHEME (ETS) AND THE EUROPEAN UNION EMISSIONS TRADING SYSTEM (EU ETS)

REGULATORY IMPACT STATEMENT

BACKGROUND

This Regulatory Impact Statement has been prepared to assess the impacts of establishing a partial linking arrangement with the European Union Emissions Trading System (EU ETS) for the period 1 July 2015 to 30 June 2018.

Scientists advise that the world is warming. High levels of carbon pollution risk severe environmental and economic damage, both within Australia and globally. The Government has committed to a long-term goal of reducing Australia's emissions and to achieving this by introducing the Australian Emissions Trading Scheme (ETS).

On 10 July 2011, the Government announced details of its Clean Energy Future package, which included the Australian ETS (starting from 1 July 2012). The legislation was designed to reduce Australia's carbon pollution and promote investment in clean energy technologies. The Bills passed into law on 8 November 2011.

The Australian ETS establishes a fixed price for three years before transitioning to a flexible cap-and-trade scheme from 1 July 2015. During the fixed price stage, Australian liable entities will be able to purchase as many carbon permits as required, at the set price, to meet their obligations under the scheme. The fixed price will be set at \$23 in 2012-13, \$24.15 in 2013-14 and \$25.40 in 2014-15.

The Government also announced a transitional price floor and price ceiling for the first three years of the flexible price stage. The price floor is intended to ensure that a minimum carbon price applies in Australia during that three-year period, regardless of international prices. The price floor on international units is intended to be implemented through a fee on the surrender of international units. The price floor is to be set at \$15 in the first flexible price year, and rise in real terms at 4 per cent per year to \$16.00 in 2016-17 and \$17.05 in 2017-18.

The Government further announced an equivalent carbon price to be applied to some business transport emissions, non-transport use of liquid and gaseous fuels, and synthetic greenhouse gases through adjustments to separate legislation. This is intended to ensure these sectors would face equivalent abatement incentives to those covered under the Australian ETS.

The price ceiling is intended to decrease upside price risk for liable entities by capping the cost of compliance under the Australian ETS for a transitional period while the carbon price is implemented and domestic carbon markets mature. The price ceiling is intended to be implemented by making available an unlimited number of carbon units at a fixed price, to be set in regulations at a level \$20 above the expected international price for 2015-16.

International emissions units can be used for compliance under the Australian ETS during the flexible price stage. Until 2020, liable entities may use certain eligible international emissions units to meet up to 50 per cent of their annual liability under the scheme. At present, this

consists exclusively of Kyoto Protocol international units (Kyoto units) – specifically, certified emission reductions (CERs), emission reduction units (ERUs) and removal units (RMUs).

Liable entities will not be able to use Kyoto units issued from the following projects to comply with the Australian ETS:

- nuclear projects;
- the destruction of trifluoromethane;
- the destruction of nitrous oxide from adipic acid plants;
- large-scale hydro-electric projects that are inconsistent with World Commission on Dams criteria adopted by the EU; and
- certain time-limited land sector projects.

In announcing the Clean Energy Future package, the Government also stated that it considered links with credible schemes, including the EU ETS and the New Zealand Emissions Trading Scheme (NZ ETS), as being in Australia's national interest. This is because an effective global carbon market will reduce global and Australian abatement costs by ensuring that the cheapest abatement opportunities are pursued first regardless of where in the world they occur.

The Government further stated that it would only consider future bilateral links with schemes that were of a suitable standard, based on a range of criteria including:

- an internationally acceptable (or, where applicable, a mutually acceptable) level of mitigation commitment;
- adequate and comparable measurement, reporting, verification, compliance and enforcement mechanisms; and
- compatibility in design and market rules.

In a closed system with no international linking, the carbon price would be determined by domestic demand and supply conditions, which would be expected to result in a significantly higher carbon price and cost of compliance. Linking the Australian ETS to international markets allows liable entities to lower their compliance costs via access to lower cost international emissions reductions opportunities.

In September 2011, the European Commission President José Manuel Barroso and Australian Prime Minister Julia Gillard announced that the EU and Australia would establish senior officials' talks that would include work on conditions for linking the European and Australian emissions trading schemes.

In December 2011, the Australian Minister for Climate Change and Energy Efficiency Greg Combet AM MP and European Commissioner for Climate Action Connie Hedegaard announced the terms of reference for the senior officials talks. Those terms of reference included examination of the mechanics of linking the two systems, and provision of advice on specific options, steps and possible timing for such linking to occur.

In March 2012, Minister Combet and Commissioner Hedegaard announced that further progress on the linking discussions had occurred.

ISSUE TO BE ADDRESSED

The policy decision to be considered is whether to adopt a package of measures which would establish a partial link with the EU ETS and include making relevant adjustments to the Australian ETS.

Linking emissions trading systems enables participants to use units from one system for compliance in another system. It provides a number of benefits, including lowering the cost of reducing carbon pollution, increasing market liquidity and supporting global action on climate change. With these benefits in mind, the Government has been pursuing discussions with the European Commission (EC) on the possibility of linking the Australian ETS to the EU ETS.

The Government has received in-principle support from the EC to establish a partial link between the two systems, with a view to negotiating a full bilateral or 'two-way' link, commencing no later than July 2018. Under the interim arrangement, Australian liable entities would be able to import and surrender European Union Emission Allowances (EUAs) for compliance in the Australian ETS for emissions liabilities that accrue from 1 July 2015, but would not be able to export Australian carbon units to the European Union until a full link is agreed.

To facilitate these arrangements and simplify the path towards full linking, Australia would not implement the price floor arrangements and would introduce an additional sub-limit on the use of eligible Kyoto units. This sub-limit would allow liable entities to use Kyoto units for up to 12.5 per cent of their annual liability, within the existing 50 per cent overall limit on the use of international emissions units.

Under these linking arrangements, it is expected (as described below) that the price of EUAs would determine the price for Australian carbon units. This would mean that the price ceiling would be set with reference to the expected EUA price. The Government intends to set the price ceiling in regulations by 31 May 2014. To account for the possibility that EUAs continue to trade at a premium to Kyoto units, the Government would also make adjustments to the equivalent carbon price arrangements in order to better reflect the effective carbon price faced by liable entities under the Australian ETS.

OBJECTIVES

The objectives sought to be achieved by linking with the EU ETS are to:

- provide Australian liable entities with secure access to a wider range of credible international emissions units;
- support the development of an effective global response to climate change through internationally-linked carbon markets; and
- take action towards meeting Australia's long-term emission reduction targets in a flexible and cost-effective way.

OPTIONS

The partial linking proposal reflects a set of arrangements between Australia and the EC. Accordingly, the options are:

- (1) establish the partial link with the EU ETS, making relevant adjustments to the Australian ETS; or
- (2) not establish the partial link with the EU ETS, and maintain current policy settings.

IMPACT ANALYSIS

This section outlines the impacts, advantages and disadvantages of linking to the EU ETS (via a partial link), including not implementing the price floor arrangements, introducing a quantitative sub-limit on surrender of Kyoto units in the Australian ETS, and adjustments to equivalent carbon pricing arrangements.

Impacts

A partial link between the Australian ETS and the EU ETS would enable liable entities to surrender EUAs for compliance with the Australian ETS during the flexible pricing period, beginning from 1 July 2015.

From this date, liable entities would be able to use eligible international emissions units for compliance for up to 50 per cent of their liabilities, with the use of Kyoto units not to exceed the 12.5 per cent quantitative sub-limit on the use of these units.

In addition to EUAs and Kyoto units, in the flexible price period, liable entities would also have access to domestic carbon units and unlimited use of Australian Carbon Credit Units (offset credits generated under the Carbon Farming Initiative).

Under the partial link, the price floor arrangements under the Australian ETS would not be implemented. Specifically, the Government would not apply the international unit surrender charge on the surrender of eligible international emissions units, and the minimum auction reserve price would not take effect under the Clean Energy legislation.

The impact of these arrangements on the domestic carbon price and the cost of compliance will depend on prevailing market prices for Kyoto units and EUAs once the Australian ETS commences its flexible price phase.

Under the carbon price projections in the 2012-13 Budget, drawn from the Strong Growth, Low Pollution modelling report (SGLP), there would be no impact on domestic carbon prices of establishing a partial link to the EU ETS under these interim arrangements. This is because the international carbon price is projected to be above the price floor and because the projections assume a single international unit price and do not distinguish between Kyoto unit and EUA prices.

If the market prices of Kyoto units and EUAs differ, with EUAs trading at a premium to Kyoto units, as they currently do:

- The Australian domestic carbon price would be expected to equal the prevailing EUA price. This is because the proposed quantitative sub-limit on the use of Kyoto units would be lower than liable entities' expected total demand for international units during

the partial link period, implying that some liable entities would need to use EUAs for compliance purposes.

- The flexibility provided by banking arrangements means that liable entities will also be able to buy carbon units and bank them for use in subsequent compliance periods. This also means it is likely that the price for Australian carbon units would equal the EUA price.
- The average cost of meeting a given domestic carbon liability would be less than the Australian carbon price. This is because all liable entities would be able to use lower cost Kyoto units for a portion of their liability, rather than meeting their full liability through the surrender of carbon units and EUAs valued at the Australian carbon price.
- The effective rate of assistance for entities receiving free domestic carbon units under the Jobs and Competitiveness Program and the Energy Security package would be higher than is currently the case. This is because liable entities that receive assistance under the Australian ETS would receive this assistance in the form of higher value Australian carbon units, but could use lower cost Kyoto units for a portion of their liabilities.
- The equivalent carbon price arrangements applied to certain fuels and synthetic greenhouse gases would be comparable to the effective carbon price faced by liable entities under the Australian ETS. If no adjustments were made to the equivalent carbon price arrangements, the effective carbon price for these sectors would be higher than that faced by liable entities.

Advantages

The proposed linking arrangement would provide Australian liable entities with secure access to credible international units from the world's largest and most mature carbon market for compliance with their obligations under the Australian ETS. It would ensure that Australian businesses have access to a broader range of credible, low-cost abatement while preserving access to Kyoto units, which remain highly credible sources of international abatement for the foreseeable future.

These arrangements would also provide Australian liable entities with a broad range of ways to manage their carbon price liability as EUAs are currently traded on fully-functioning secondary markets with well established forward price curves and established derivative instruments. Linking with an established carbon market with these characteristics could improve the overall stability and ongoing credibility of the Australian ETS.

The linking arrangement would also lower transaction costs for entities that have liabilities under both the Australian ETS and the EU ETS. Current estimates are that around 50 Australian liable entities (responsible for approximately one-third of covered emissions in Australia) also have a liability under the EU ETS.

Not implementing the price floor would address concerns raised by some liable entities in regards to uncertainty associated with not knowing the level of the international unit surrender charge when entering into forward contracts. It would also avoid administrative costs needed to implement the international unit surrender charge and minimum auction reserve price.

Establishing a partial link with the EU ETS would support the development of international carbon markets, which is in Australia's national interest. The arrangement would represent the first step towards linking the established European carbon market with a new carbon market in

the Asia-Pacific region. Together, the linked Australian ETS and EU ETS would be the world's largest carbon market and a major driver of a transition to a global low-carbon economy.

The proposed sub-limit means it is likely that some EUAs would be used by liable entities for compliance with Australian ETS obligations, and that the carbon price that would apply in Australia would be consistent with the carbon price applying in the EU ETS. This would provide for a smooth transition to a full bilateral link in 2018. It would also ensure that a significant level of incentive was provided to invest in renewable and low emissions projects, commensurate with the level of incentive applying in the EU ETS, imposing an effective floor price in the Australian ETS at the level of the EUA price.

The likely use of EUAs by liable entities for compliance with Australian ETS obligations will build linkages between carbon market participants in Europe and Australia, and enable Australian liable entities to take advantage of EU ETS market features.

It would also enhance the prospects of the two-way link proceeding as it would more effectively integrate the two emissions trading schemes during the interim period than would a situation in which no or very few EUAs were to be used in the CPM.

Disadvantages

These linking arrangements would imply that prices of Australian carbon units would be impacted by decisions in Europe. In particular, steps to support the price of EUAs (including temporary delay and possible withdrawal of EUAs from auctions over the 2013-20 trading period, as announced by the European Commission in July 2012) would be expected to flow through to the carbon unit price and the price paid by Australian liable entities in the flexible price period. However, the timing and extent of any price impact is uncertain ahead of a final EU decision on the volume and schedule of EUAs to be deferred or withdrawn, and will depend on the response to this final decision by carbon market participants.

Some price linkages are already expected to occur under the current policy settings as the two emissions trading schemes are indirectly linked through the market in Kyoto units, which are able to be used in both schemes. EU policy decisions typically have an impact on the price of Kyoto units.

Risks of price impacts arising out of European decisions could also be managed to some extent by the inclusion of consultation and notice periods in the bilateral linking arrangements. Such arrangements would enable the Government opportunities to determine policy measures, if these were required, to prevent excessive impacts on Australian liable entities.

The proposed partial linking arrangements would reduce the quantity of Kyoto units that liable entities may use for compliance. This means that liable entities intending to use Kyoto units in excess of the sub-limit could face additional administrative costs associated with sourcing alternative units for compliance.

Australian companies that have invested in Kyoto projects, with a view to using or selling them for compliance with the Australian ETS, may also be affected by the sub-limit. However, they would likely be able to make alternative arrangements for the sale of these units.

Industry stakeholders may be concerned about the change in compliance arrangements. However, these changes would be consistent with the Government's long held policy that linking is in Australia's national interest, and there would be around three years of prior notice before the new arrangements come into effect.

CONSULTATION

During public consultations on the carbon pricing framework in 2011, and emissions trading more generally from 2006, most stakeholders expressed support for international linking as long as eligible units met suitable quality criteria. There has been consistent support for continued efforts to develop direct bilateral or regional links in the future.

A number of environmental groups, green business organisations and industry stakeholders also commented on price floor arrangements and on the quantitative limits on use of international units (that is, on the existing restriction that no more than 50 per cent of an emissions liability may be met using international units for the first five years of the flexible price period).

In relation to the specific details of this linking arrangement, there has been a need to maintain confidentiality due to the potential impact on operating carbon markets.

CONCLUSION/RECOMMENDATION

The Government has already agreed that it is in Australia's national interest to link to credible international emissions trading systems and the Prime Minister has announced the intention to link the Australian ETS to the EU ETS. The Government has also agreed that any restrictions on use of international emissions units would be to ensure:

- the stability and ongoing credibility of the Australian ETS;
- the environmental integrity and effectiveness of the carbon price; and
- consistency with Australia's international objectives and obligations.

It is recommended that the Government establish a partial link between the Australian ETS and the European Union Emissions Trading System (EU ETS) including:

- not implementing the price floor; and
- introducing an additional quantitative sub-limit of up to a specified percentage on the use of eligible Kyoto units for compliance with obligations under the Australian ETS. This sub-limit percentage should be set such that some EUAs are used for compliance, while retaining access to Kyoto units.

Taken together, this package would:

- provide Australian liable entities with immediate access to credible international units for compliance via the world's largest carbon market for the first three years of the flexible price period;
- lower transaction costs for businesses that have liabilities under both the Australian ETS and EU ETS;
- improve the overall stability and ongoing credibility of the Australian ETS;
- avoid potential complexity associated with the implementation of the price floor arrangements; and
- further support the development of global carbon markets and hence global action on climate change.

IMPLEMENTATION/REVIEW

The Government would aim to provide liable entities with notice of modifications to the Australian ETS and the introduction of one-way linking arrangements, as soon as possible after a decision is made, through a joint announcement between the Australian Government and the European Commission.

The price floor would not be implemented, initially by a decision not to make regulations under the *Clean Energy (International Unit Surrender Charge) Act 2011*, and then by removing price floor provisions through amendments to the Clean Energy legislation.

A quantitative sub-limit on Kyoto units would be implemented through amending the Clean Energy legislation to enable the Minister for Climate Change and Energy Efficiency to make regulations setting a quantitative sub-limit for the use of specific classes of eligible international units, within the overall 50 per cent surrender limit.

The Government will aim to finalise arrangements for the interim one-way link by July 2013, with a view to negotiating an agreement by July 2015 for a full bilateral link to commence by July 2018.