Australia and EU link carbon markets

Australia is set to join the EU's carbon emission trading scheme in what could be the first step towards a global carbon market, but is Europe's troubled market the best model for such a mechanism? Damon Evans reports

AUSTRALIA and the EU have agreed to link their carbon markets in a move they claim will lay the foundation for a global trading system to cut greenhouse gas emissions.

In theory, analysts agree that a market-based system to mitigate climate change will only succeed if it is international in scope, allowing firms to compete on equal terms. In reality, however, some see the deal as little more than a matter of political convenience.

Broadly speaking, Australia's support provides sorely needed validation for a centrepiece of European climate policy that has been beset by problems since its inception in 2005. A combination of industry lobbying and recession has left the European market so saturated with permits to emit carbon that prices have slumped and imposed no real penalty on carbon-intensive industry and power generation.

However, the federal government's recent changes to the Australian carbon pricing system – coming just two months after the system's introduction – is widely seen as an attempt by Australia's unpopular minority Labor government to build electoral support ahead of a federal election next year.

Under the revised deal, Australian companies will gain access to cut-price European permits from 2015. The price curve for EU Allowances (EUA) future contracts over 2008-2012 flattened dramatically, with prices dropping from a peak of €35 ($44)/EUA in 2008 for the December 2012 EUA contract, to just over €9/EUA for the December 2015 contract in August 2012.

Australian firms are likely to pay much less than they would have under the previous, deeply unpopular, plan to fix an initial price floor of A$15 ($15.34) a tonne when the current fixed-price tax moves to a floating market-mechanism in 2015. Australia's current carbon price, introduced in July, of A$23/t is the highest in the world. By 2020, Canberra aims to slash emissions to 5% less than the level recorded in 2000.

Businesses in Australia will be able to use European permits to cover up to 50% of their emissions from July 2015, but European firms will have to wait until 2018 to use Australian allowances. Australian companies will also be able to cover up to 12.5% of their liabilities with UN-backed Certified Emissions Reduction credits (CERs), which are trading near record lows around €3/t. The total quota for international permits is capped at 50%.

Melbourne-based carbon analysts RepuTex say the policy change is a positive development for emissions trading in Australia. Access to the EU Emissions Trading Scheme (ETS) provides Australian businesses with a more predictable price trajectory than would have been the case under the previous proposal.

Reducing costs

Significantly, the tie-up with the world's largest carbon market could save liable Australian companies around 16% – A$2.5 billion – between 2015 and 2020, relative to the previous floor-price scenario, according to RepuTex. The savings are calculated on forecasts of European and international carbon permits trading between 2016 and 2020 at an average of A$11.50/t.

RepuTex says winners would include power generators, which will save about A$1.5 billion on previously expected costs over the period, while coal miners can expect a windfall of up to A$560 million and LNG producers, one of up to A$230 million.

"RepuTex forecasts that Australian LNG producers will face slightly lower liabilities through FY2016-2018 under the EU-linked scheme than they would have under the Australian floor price," the firm said.

"We expect Australian LNG producers will face a reduction in carbon costs of approximately A$230 million over the short-term as a result of the EU linkage, but potentially higher long-run costs. Considering the long operational life of most LNG facilities, Australian LNG producers will be keeping an eye on long term price trends, however, the long-run differential in liabilities won't be enormous, especially as most of these plants will be compensated, as a trade-exposed industry, for around two thirds of their emissions."

However, the EU is planning to restrict the supply of permits to force prices higher and the carbon consultancy says the timing and size of any restriction will be crucial in calculating savings for Australian companies.

RepuTex research director, Paul Bourke, expects the EU in 2018 to reintroduce any permits pulled out of the market, but cautions prices could rise if they are not put back into the market until 2020. In this case, overall carbon prices will be higher compared to the floor-price scenario, warned Bourke.

Depending on the volume and duration of policy measures taken in the EU, RepuTex believes EUAs available from 2015-2020 will trade between A$7/t and A$17/t and that Australian buyers will use the EUAs and CERs to

Global market: The European/ Australian link could be the launchpad for a worldwide partnership

meet around 22% of their total liability over the period.

While the cheaper CERs are expected to make up most of the demand from Australia for international units, demand for EUAs could rise to 77 million tonnes of carbon emitted by the end of the decade, says RepuTex.

Australia's interest is positive in that it bolsters the credibility of the battered EU carbon market, but it is unclear what the real volumes required by the Australian market will be, Renee Howarth, energy markets analyst at consultancy Wood Mackenzie, told *Petroleum Economist*.

How positive remains to be seen. The tie-up could simply see the addition of another small country, like the Netherlands or Belgium, into the EU market or it could herald a much larger expansion. Whether it is the beginning of a global market, though, is difficult to say, she added.

Deutsche Bank analyst Isabelle Curien warned that a firm commitment is still needed to get linking in place by 2018, which would require more political and diplomatic efforts.

Australia's federal elections, due next year, could throw a spanner in the works. Tony Abbott, leader of the Liberal-National opposition coalition, says the decision to link with the EU scheme and remove the price floor was an admission by the government that they had got the carbon price fundamentally wrong. And the coalition says that hooking up with Europe's carbon market will make it easier to axe the scheme, by giving firms a market to resell unnecessary forward-dated permits.

Howarth rejects this line of reasoning, saying the international link-up and the push for the EU to mandate the alliance could, potentially, make it more difficult to roll back the scheme.

The Labor-led minority government says that businesses had made it clear they wanted more flexibility on the carbon price once Australia moved to a trading scheme. Officials added the move will see the federal government exchange a short-term price floor for long-term stability.

Increased certainty

Analysts agree the move offers more certainty than the previously proposed floor price and 50% quota for CERs, which would have required a significant penalty be paid to make up the difference between the Australian floor price and what are expected to be much lower CER prices.

As a result of the tie-up, a forward price curve for EUAs will exist for Australian buyers to benchmark their compliance costs against, which is a useful development for the introduction of emissions trading under a floating price in Australia.

Having demand outside the EU should help increase European prices, but given the relative size of the markets, Australian demand may not be enough to significantly reduce the glut of permits that are currently depressing prices. However, the EU aims to forge further links to emerging carbon markets in South Korea and a number of US states. The bloc is also focused on China, which is developing a pilot project to open carbon markets in seven areas, including Beijing and Shanghai.

But even as it tries to expand its market, there is a tense internal debate in the EU over potential reforms to its trading system that would support persistently weak prices, thus giving businesses greater incentive to invest in green technologies. One analyst claimed that, rather than pursue an international expansion, the EU should focus on overhauling "a flawed model that has proved to be ineffectual." ●