

SENATE ENVIRONMENT AND COMMUNICATIONS REFERENCES COMMITTEE

Inquiry into the Government's Direct Action Plan

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Senators

The Choice Between Two Sets of Policies

It is not possible to assess the proposals put forward for discussion in the Green Paper on an Emissions Reduction Fund in isolation. As the Government has explained, the Emissions Reduction Fund, if established, would be the central part of a set of emissions reduction institutions and policies under the rubric of “Direct Action”. The Government is proposing that this set of institutions and policies replace a set of institutions and policies established by law through decisions of the Australian Parliament. In particular, the Government proposes that the laws establishing three institutions (Carbon Pricing, the Climate Change Authority, and the Clean Energy Finance Corporation) be repealed. It is not proposed that two other established institutions with embedded policies that play an important part in established mitigation efforts be repealed—the Renewable Energy Target, and the Australian Renewable Energy Agency (ARENA). However, the Renewable Energy Target is subject to a review under a Chair who is on public record with statements that modern science is wrong in its knowledge that human activity is a major contributor to global warming. The main question about the future of ARENA relates to whether adequate financial resources will be provided through the budget for it to function effectively in its contribution to reducing greenhouse gas emissions. The Green Paper proposes that two institutions established alongside Carbon Pricing—the Clean Energy Regulator and the Carbon Farming Initiative, be retained for roles within Direct Action.

So the question to be addressed is whether the Emissions Reduction Fund and associated policies and institutions are better than the institutions and policies currently established by law.

Better at what?

The science on climate change provides the entire purpose of climate change mitigation policies. There is value in reducing greenhouse gas emissions because the best of Australian and international scientific analysis says that in the absence of effective global mitigation, increasing concentrations of greenhouse gases in the atmosphere are expected to heat the atmosphere and oceans to an extent that imposes large costs on humanity; and the best of Australian and international economic analysis tells us that the cost of Australia doing its fair share in a global mitigation effort would be less than the costs of climate change avoided.

If we do not accept the knowledge that Australian and global science has discovered about climate change, there is no reason to reduce greenhouse gas emissions. There is no point in continuing established policies, or in replacing them with Direct Action.

The current Australian government and the major Opposition political parties outside government accept the validity of the science. The international community through the United Nations Framework Convention on Climate Change has agreed on an objective for climate change mitigation policies: to reduce emissions enough to create a reasonable chance that human-induced warming is held to no more than 2 degrees Celsius. The Australian Government accepts that objective. The Australian Government accepts that Australia should do its fair share in a global mitigation effort. It accepts that this fair share is to reduce emissions from 2000 levels by 5% whatever other countries are doing, by 15% under a set of conditions that can be summarized as “if other developed countries are making comparable efforts and developing countries are significantly reducing emissions trajectories”, and by 25% in the context of the global effort putting the world on a path to achievement of the 2 degrees objective. It accepts that further emissions reductions should be made beyond 2020 in line with increases in the global effort.

The current Government's commitments to strengthening the targets beyond minus 5% in the context of specified international action are clear and unqualified. In Opposition and in Government, including through the 2013 election campaign, the new Government has said that it will definitely meet the targets that it shares with the former Government that is now the Opposition. It says that the difference between its own position and that of the previous Government is simply that it will reach shared targets through different means.

The Australian Parliament has given the Climate Change Authority the responsibility under Australian law of advising on appropriate Australian targets for emissions reductions. The Authority is required by law to take account of developments in the science, actions by other countries and other relevant matters. In its paper released last week, *Reducing Australia's Greenhouse Gas Emissions: Final Report*, the Climate Change Authority advised that the appropriate 2020 emissions reduction target for Australia in the light of actions by other countries is minus 19%, of which 4 percentage points would be contributed by the overachievement of the 2008-12 target that Australia accepted under the Kyoto Protocol. The Climate Change Authority noted that Australia may be required to do more than this if the 2015 Paris Conference of the Parties to the UN Framework Convention on Climate Change leads to other countries strengthening their 2020 targets. Australia would have to be ready for a faster rate of emissions reductions after 2020, as an acceleration of the global effort would be necessary to achieve the 2 degrees objective.

My own assessment is that an emissions reduction target of minus 15% is required in the light of Australia's commitments to the international community, the Government's domestic political commitments, and the current emissions trajectories of other countries. I myself would recommend keeping the credits from over-achievement of the Kyoto Protocol targets as insurance against any future shortfall against emissions reductions targets. The 15-19% is broadly consistent with the minus 17% target of the United States, which has been followed by Canada and towards which both countries are making progress—two countries that, like Australia, have exceptionally high emissions per capita.

So the question is: which of Direct Action embodying the Emissions Reduction Fund, and the policies currently established under Australian law, will see Australia meeting its commitments to the Australian and international communities at lower economic costs?

The Green Paper as a Basis for Choice

The Green Paper does not specify the objective of the Emissions Reduction Fund. It does not attempt to analyse the costs of meeting even a minus 5% target through Direct Action and the Emissions Reduction Fund. In this it is an unusual document, lacking any semblance of the framework of public interest analysis that is a characteristic of Australian policy-related papers of modern times. It is not a Green Paper in the sense that the term has been used in Australian public policy.

The Green Paper makes no effort to meet the elementary requirements of good practice with new regulation: to clearly define the problem for which regulation is proposed as a solution; to clearly identify the objectives of government action; and to specify alternative means of meeting the specified objectives (see the Commonwealth of Australia, *Best Practice Regulation Handbook*, July 2013).

Nor does the Green Paper fully define the arrangements under which the Emissions Reduction Fund would work. A baseline and credit scheme of the kind contemplated requires baselines to be established for old and new firms, with incentives for over-achievement and penalties for underachievement. The setting and enforcement of baselines is an immense bureaucratic task. The Paper makes only vague reference to the need for such requirements and says nothing about how the requirements will be met.

Rather than a Green Paper, what is before the Senate is a shooting of the breeze: the raising of a few of the questions that would need to be answered along the way to preparing a Green Paper.

Considerable time will pass before the Senate has before it the basic documentation upon which a responsible decision could be taken on whether to replace established policies by Direct Action.

Reasons Why Direct Action is Likely to Cost More For Less Reduction in Emissions

The introduction of the established mitigation institutions and policies has coincided with a reversal of the longstanding tendency for Australian emissions outside the land sector to rise rapidly except in large economic downturns. Emissions have started to fall since mid-2012. The turnaround is concentrated in sectors that have been the subject of strong policy intervention, with emissions still rising in some sectors that are not covered by the main policies. The reduction of emissions is largest in the electricity sector, where the interaction of the Renewable Energy Target, Carbon Pricing and energy efficiency programs has had powerful effects, and will soon be joined by contributions from the Clean Energy Finance Corporation and larger contributions from the Australian Renewable Energy Agency.

The Final Report of the Climate Change Authority confirms earlier analysis, and shows that established policies allow stronger targets to be met at relatively low cost.

The Climate Change Authority's recent Final Report demonstrates that policy has made a substantial contribution to the reductions in emissions trajectories—the Renewable Energy Target, Carbon Pricing, energy efficiency programs, and other measures.

The Green Paper takes comfort from the recent fall in emissions trajectories, seeing these as evidence that the meeting of targets will be easier than had once been anticipated. These hopeful assessments rely on the continuation of trends in emissions that flow from institutions and policies that the Government proposes to abolish or to amend.

The Green Paper takes comfort from a Climate Works paper on the cost of abatement, that suggests that there are many opportunities for reducing emissions at low cost or in some cases with profit to the

enterprises with opportunities to reduce emissions. It seems to suggest that low cost abatement opportunities of the kind described in the Climate Works paper will manifest themselves as offers to reduce emissions at low cost. It does not ask why firms are not now reducing emissions if it is indeed the case that reductions in emissions would increase profitability. It ignores the business reality that if incentives for firms to reduce emissions are reduced, then the rate of reduction in emissions will fall. This is an important reality, since incentives to reduce emissions would be much weaker under the Emissions Reduction Fund at rates of funding currently proposed than under Carbon Pricing linked to Europe.

Incentives to reduce emissions under the Emissions Reduction Fund would only be as large (not larger) as (than) under carbon pricing if the Fund were large enough to offer prices as high as the carbon price for all abatement available at that price. Acceptance of all offers at this price would be an immense drain on the budget. Incentives to reduce emissions would be weaker than under existing policies at any lower price or coverage. By a time just beyond the reach of the current forward estimates, the turnaround in the budget involved in provision of incentives from the Emissions Reduction Fund similar to those currently provided by Carbon Pricing would have a lower limit of around \$4-5 billion per annum at current European prices (\$A10.66 in London and Frankfurt on Wednesday this week). This comprises around \$3 billion per annum which is simply net revenue lost at current European prices from abolition of Carbon Pricing, and \$1-2 billion outlays on purchases by the Emissions Reduction Fund.

This point can be made in relation to “carbon farming” within the established Carbon Farming Initiative (CFI). The Green Paper envisages large reductions in emissions coming from carbon farming. Farmers would develop abatement projects and bid for payments from the Emissions Reductions Fund. Only those projects that win in a competitive process receive payments; there would be financial risk in spending money on preparation of projects to support bids. Even for the winners, incentives would not be as large as under established policies—where all CFI credits attract the full carbon price without risk—unless the price at which abatement is purchased is equal to the carbon price under established policies, and the Fund were large enough to purchase all abatement that would have earned credits under established policies.

A Fund large enough to provide similar incentives for emissions reduction to those under existing policies would see a deterioration of the budget of around \$4-5 billion per annum at a lower limit.

There are five big reasons why the budget deterioration budget would exceed this lower limit if the Fund were large enough to meet Australia’s mitigation commitments. .

First, the above analysis presumes that all existing emissions reduction policies are retained in their established form when Carbon Pricing is replaced by the Emissions Reduction Fund. Any weakening of those policies—for example by reducing the 2020 requirements for supply of electricity from renewable sources under the Renewable Energy Target below the currently legislated 45Twh per annum, or removal of established programs to improve energy efficiency, would increase the load that had to be carried by the Emissions Reduction Fund, and the fiscal cost of carrying the load.

Second, the lower limit of budget deterioration of around \$4-5 billion per annum is based on a target of reducing emissions by 5% by 2020: higher targets, as required by the Australian Government’s domestic political and international commitments, would expand the budget deterioration.

Third, European and therefore Australian prices would be much higher in the likely event that there is stronger global mitigation effort in future.

Fourth, the opportunity to trade with Europe and (with limits) developing countries within the Clean Development Mechanism places caps on the cost of abatement within established policies but not within Direct Action. The specification under Direct Action that all abatement is to be achieved within Australia would require prices that were much higher than would otherwise be necessary for Australia to do its acknowledged fair share in an international mitigation effort.

The fifth and perhaps most important reason why the \$4-5 billion per annum deterioration of the budget would be a lower bound is that whereas established policies impose clear and comprehensive penalties (the need to purchase more permits) on increases in emissions above current levels, it is not clear from the Green Paper whether and the extent to which abatement through the Emissions Reduction Fund would place restraints on growth in emissions in enterprises that were not receiving payments for reductions in emissions. The volume of purchases of abatement by the Fund would rise with each increase in emissions from other enterprises. There would also be an increase in the price that has to be paid for each tonne of abatement.

The fifth of these points would be a large and obvious flaw in an emissions reduction policy, and source of pressure on the budget. If the Government were committed to meet its targets through the Emissions Reduction Fund, this flaw may lead a Government seeking to meet its emissions targets to set baselines for each enterprise and penalties for emissions in excess of the baseline. Without a national cap of a kind that is present under established Carbon Pricing policies, the baselines and penalties would need to be set business facility by business facility. This would be a huge bureaucratic exercise. Comparable reductions in emissions to those under established arrangements would only be achieved if the coverage of enterprises by baselines and penalties was as comprehensive as that under the established carbon pricing arrangements, and if the penalty per unit of emissions in excess of the baseline was as high as the carbon price under established policies.

If \$4-5 billion per annum is a lower bound on the budget deterioration of the budget associated with the shift from Carbon Pricing to an Emissions Reduction Fund that allows Australia to meet its domestic political and international mitigation commitments, what might be an upper bound? Few would doubt that it could extend beyond several times the lower bound.

So if established policies were replaced by Direct Action with an Emissions Reduction Fund at its centre, and the Government were committed to the targets that have been the subject of domestic political and international commitments, there would be massive deterioration in the budget outcomes—rendering much more difficult and perhaps practically impossible the fiscal adjustment which is required for sustained economic stability in Australia after the resources boom. It is less certain that the Australian Government would meet its domestic political and international commitments on emissions reduction through an Emissions Reduction Fund—even if massive budgetary resources were available. The new policies based on the Emissions Reduction Fund would introduce a risk that is not present with established policies, that the budgetary consequences of meeting the Government's domestic political and international commitments would be so large as to block achievements of the targets. And even if adequate funds were made available to meet the targets and other risks were managed consistently with meeting the targets, Direct Action would be associated with immense new regulatory interventions with large costs to individual enterprises and to the economy.

The Proposed Economic Benefits of “Removing the Carbon Tax”?

The two main economic difference between the two approaches to Australia contributing its fair share in a global mitigation effort—established policies and Direct Action with the Emissions Reduction Fund—have already been identified: the larger budgetary demands and bureaucratic interventions under Direct Action.

But what of the supposed benefits to business or households from removing the "Carbon Tax"?

The supposed gains depend on the established policies being replaced by nothing at all rather than an Emissions Reduction Fund within a program of Direct Action.

But even if the established mitigation arrangements were repealed and replaced by nothing at all or not much more than nothing (as would be the case within an Emissions Reduction Fund that continued to have only the scale of financial resources currently envisaged by Government policy), the short-term economic gains from repeal have been greatly exaggerated by the Government and the Australian business lobbies (and I note this week's joint statement from the Business Council, the Chamber of Commerce and Industry, the Mining Industry Council and the Australian Industry Group).

The short-term economic benefits of repeal without replacement are said to come in two ways: the increase in the profits of companies with direct or indirect exposure to Carbon Pricing; and the reduction in the cost of living of households.

Of course, the two kinds of benefits are exclusive of each other. To the extent that the costs of carbon permits compress business profit margins, they do not increase household costs of living.

Economic analysis suggests that in the general case of competitive markets, the carbon costs of trade-exposed goods and services will be absorbed by the enterprises, and the carbon costs of non-traded goods and services passed on to users of the products. This is not the whole story for traded goods and services, as the increase in costs associated with carbon pricing will lead to some depreciation of the real exchange rate, offsetting the effects of carbon pricing on trade-exposed industries to some extent. And trade-exposed industries can pass on cost increases to the extent that competitors in other countries are subject to higher costs as a result of requirements to reduce emissions, whether or not those costs are imposed by Carbon Pricing. Neither is it the full story for non-traded goods and services where there is monopolistic or oligopolistic pricing, as the monopolist or oligopolist has some discretion about whether to hold back some of the cost increase in an attempt to increase sales.

The established policies gives large protection against loss of competitiveness in the most emissions-intensive of the trade exposed industries, through the issue of free permits. The amount of free permits is set according to emissions intensities prior to carbon pricing and not diminished if the firm takes steps to reduce emissions. As a result, many trade-exposed industries—apparently including ALCOA, owners of the Point Henry aluminium smelter—so far have made a profit out of the carbon pricing arrangements, even if we take no account of effects on the exchange rate or competitors having to incur costs in reducing emissions. There is a partial exception in the coal industry, but even there the net costs of carbon pricing on profitability are tiny compared with the effects of recent fluctuations in the exchange rate and coal prices (see my 2013 book *Dog Days: Australia After the Boom*, p 209).

For the non-traded industries, carbon costs have been passed through to consumers to the extent anticipated in the Treasury modelling that preceded introduction of Carbon Pricing. This is demonstrated in the similarity of actual consumer price increases with the increases anticipated in the modelling.

Australian consumers with low or middle incomes were fully compensated for the price increases by tax cuts (an increase in the tax-free threshold) or adjustments to social security payments.

Early this week, the Chief Executive Officer of Qantas said that recent losses of the company were not related to Carbon Pricing. Later in the week he made the opposite suggestion, by drawing attention to the amount of money that had been spent on compliance with the carbon laws, and saying that the competitive environment had not allowed the recoupment of outlays in air fares. Which of the contradictory statements from Qantas is likely to have been correct?

Qantas' international activities are trade-exposed. These are not subject to Carbon Pricing, so profits in this business could not have been affected by Carbon Pricing.

Qantas' domestic activities are subject to competition only from companies that are subject to Carbon Pricing in exactly the same way as Qantas. In a competitive market, costs would be passed on to consumers. However, in the oligopolistic civil aviation market, one or other or both of the airlines may choose to seek a higher market share by absorbing increased costs. In this case, consumers receive a windfall benefit. Consumers have benefitted at least in the short term by a Qantas domestic market strategy that has given higher priority to market share than profits. The "competitive market" that has "prevented" the passing on of cost increases follows directly from Qantas' domestic marketing strategy.

A Time For Prudence

There is good reason to be cautious about deciding now to replace established institutions and policies by Direct Action. A prudent Senate would insist on seeing a fully developed alternative before it agreed to repeal established policies.

Established policies have imperfections, and have some costs (although costs that are small in the scheme of challenges facing our country). If there were no risk of dangerous climate change, a wise Government would repeal the laws that underpin established policies and would not replace them. But that is not the situation in which we find ourselves. Climate Change is real, human activities are its main cause, there will be serious disruption of our prosperity and our civilization if we do nothing to combat it, and the chances of avoiding disruption are greater if Australia does its fair share in an effective global mitigation effort.

The Government has placed the Senate in the situation of a judge of a Martian beauty contest. The Senate was introduced to some indelicate features of the first contestant (the established policies) and invited to award the prize to the second contestant (Direct Action) while the second was still hidden from view. In the Green Paper on the Emissions Reduction Fund, the Government has lifted part of the veil which has hidden the second contestant. We have seen some gnarled toes, and people who are expert in these things can guess at the shape of the rest of the body. The glimpse of the second contestant should make us cautious about awarding the prize to the Martian under the veil until the second contestant is in full view.

The indelicate feature of the established policies that did most to attract support for the unseen Direct Action was the setting of a fixed carbon price in the first three years of Carbon Pricing. When the European carbon price collapsed in 2011, under the influence of persistent recession in much of Europe, the Australian price was well above the European. This feature of established arrangements was highlighted by the Member for Fairfax in the House of Representatives, Clive Palmer, in his address to the

National Press Club on 12 February 2014. Mr Palmer said that Australian carbon permit prices were round \$27 per tonne, when European prices were around \$3.

A fixed price on carbon is sometimes called a “carbon tax”, and came to be known by that name in the Australian discussion of Carbon Pricing. It was the fixed price that then Prime Minister Rudd proposed to abolish when he said he would “abolish the carbon tax” in statements prior to the 2013 election, by bringing linkage to Europe forward from July 1 2015 to July 1 2014. Presumably it is abolition of the fixed price that the Business Council, the Chamber of Commerce and Industry, the Australian Industry Group and the Mining Industry Council had in mind when their joint statement endorsed the then Government’s 2013 proposal to abolish the carbon tax.

Actually, linkage to Europe would generate Australian carbon costs about 7% lower than prices in the European Emissions Trading System in at least the early years, as Australian enterprises are allowed to acquit 12.5 % of their carbon obligations through purchase of United Nations Clean Development Mechanism (CDM) credits which currently have very low prices, compared with the 5% allowed in Europe.

The unattractive feature of the established arrangements that has been highlighted by the Member for Fairfax Clive Palmer, former Prime Minister Kevin Rudd, and by implication the four industry lobby groups is due to disappear in the middle of 2015. In my view, there would be no harm in “abolishing the carbon tax” in the sense used by the then Prime Minister last year: bringing forward the linkage to Europe to July 1 2014. This would increase the 2014-15 budget deficit by several billion dollars, but the associated one-off increase in Commonwealth debt would be manageable in the circumstances, and with unemployment high the Treasurer may welcome short-term stimulus that has no long-term budgetary effects. All of the comparisons in this submission of the budgetary impact of established policies with the budgetary impact of Direct Action are on the basis that established policies already embody the link to Europe.

So I commend to this Senate Committee the support of early linkage to Europe. This is likely to reduce the carbon price by more than half without removing any of the features of established policies that make them suitable instruments for meeting Australia’s medium-term and long-term mitigation commitments at moderate cost. Of course, the Government and the House of Representatives would need to agree that this was a sound course of action.

Meanwhile, the Government can develop its proposed White Paper on the Emissions Reduction Scheme, allowing the Senate at some later time to assess responsibly the relative merits of established policies modified by early linkage to Europe, and a fully revealed proposal for Direct Action.

Ross Garnaut

6th March 2014