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## Submission to the Senate Select Committee on Climate Policy

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# 1. INTRODUCTION

The Climate Institute welcomes the opportunity to submit its views to the Senate Select Committee on Climate Policy.

Established in late 2005, The Climate Institute is a non-partisan, independent research organisation that works with community, business and government to drive innovative and effective climate change solutions.

Our vision is for an Australia leading the world in clean technology use and innovation, with clean and low carbon solutions a part of everyday life throughout the community, government and business.

The Climate Institute is primarily funded by a donation from the Poola Foundation (Tom Kantor Fund).

## Focus of submission

This submission focuses on three areas:

1. The Objects of the Act and setting scheme caps and gateways;
2. The treatment of emission intensive trade exposed industries (EITEIs); and
3. Inadequate revenue direction to:
  - financing mitigation and/or adaptation in developing countries, and
  - low emission technology research.

These issues are examined through two main lenses:

1. Does the CPRS in its current form help or hinder the achievement of global climate regime consistent with Australia's national interest?
2. Does the scheme help unlock the low carbon investment required for Australia to prosper in a carbon constrained world?

While not a central focus of this submission, we have also included a brief critique of the baseline-and-credit approach to emissions trading, which has been proposed by some as an alternative to the cap-and-trade model preferred by the Government (see Annex 1).

## Summary of key recommendations

This submission includes a number of recommendations for the CPRS. These are briefly summarised, below:

1. The legislation should be structured in a way that allows the flexibility for Australia to accept a 2020 target consistent with the national interest in Copenhagen in December 2009. In the context of a global effort to that target, Australia's fair share is at least 25 per cent reductions of 1990 emissions by 2020

2. The legislation should require the Minister to consider Australia's national interest of stabilising greenhouse gas levels at 450 ppm or lower when setting targets, caps and gateway.
3. The legislation should include a commitment to review, recalibrate and ultimately remove the assistance for EITEIs as soon as a new international agreement enters into force and/or Australia's trading partners introduce domestic policy measures resulting in a direct or indirect carbon price.
4. A trigger should be placed in CPRS legislation to review EITEIs assistance as soon as any new international agreement is negotiated, with changes flowing from the review immediately where this involves no material net disadvantage (contingent on the agreement entering into force).
5. The default carbon productivity improvements for EITEIs assistance should be increased to at least 4% per annum. It could also place a cap on the growth of free permits.
6. The Productivity Commission, or similar organisation, should be empowered to annually report to the Parliament on real, proxy and shadow carbon prices in competitor countries.
7. Assistance should be tied to a requirement for recipients to prepare and publically report annual and externally audited statements on abatement opportunities. For example, by strengthening the Energy Efficiency Opportunities program including through: extending to greenhouse gas emission abatement opportunities for those receiving EITEI assistance, stronger public reporting requirements on energy efficiency opportunities with longer paybacks; and greater external auditing. Mandatory uptake of energy efficiency opportunities should be foreshadowed as a future option, pending a full evaluation of the EEO program.
8. The legislation should include a commitment to move to full auctioning of carbon pollution permits, with revenue to be channelled towards the following priorities: vulnerable low income communities; research, development and deployment of clean technologies; and support for adaptation and mitigation in developing countries.

## 2. FIRST PRINCIPLES

### No time to delay effective legislation

The Climate Institute believes the introduction of an effective emissions trading scheme in Australia is a long overdue reform and one critical element of an effective domestic response to climate change.

Setting a price on carbon pollution is one of the simplest and best measures to encourage business to invest in emission reductions. Setting a price will allow the market to find the most cost-effective technologies, provide incentives for innovation and create a level-playing field for business and consumers. An effective emissions trading scheme not only sets a price but, driven by appropriate medium term and long term goals, ensures ongoing investment and innovation.

Some argue that the Federal Government should delay the introduction of the Carbon Pollution Reduction Scheme (CPRS) given the current state of the global economy. However, as Treasury noted, those countries that move first to reduce emissions will gain a competitive advantage in the carbon constrained world.<sup>1</sup>

There is growing momentum globally recognising that the current crisis provides an opportunity to build low emission industries and jobs that can be an integral part of the economic recovery.<sup>2</sup> As the World Economic Forum noted earlier this year:

Investors and policy-makers are facing an historic choice. At the very time when commentators are branding green investing as a luxury the world cannot afford, enormous investment in the world's energy infrastructure is required in order to address the twin threats of energy insecurity and climate change. Waiting for economic recovery, rather than taking decisive action now, will make the future challenge far greater. ... Despite the recent turmoil, the world's financial markets are up to the financing challenge, but they will need continued action from the world's policy-makers and leading corporations.<sup>3</sup>

Recognising the short and long-term economic benefits of action on climate change, many countries are already placing a low carbon recovery at the heart of their economic stimulus packages. Generous assessments suggest that 23% – or USD430 billion – of recent fiscal stimulus expenditure and financial guarantees has been committed to low carbon infrastructure and investments. Others suggest the figure is closer to 8%. There is also a significant regional variation between countries. For example, initial estimates suggest China has committed around 34% of its economic

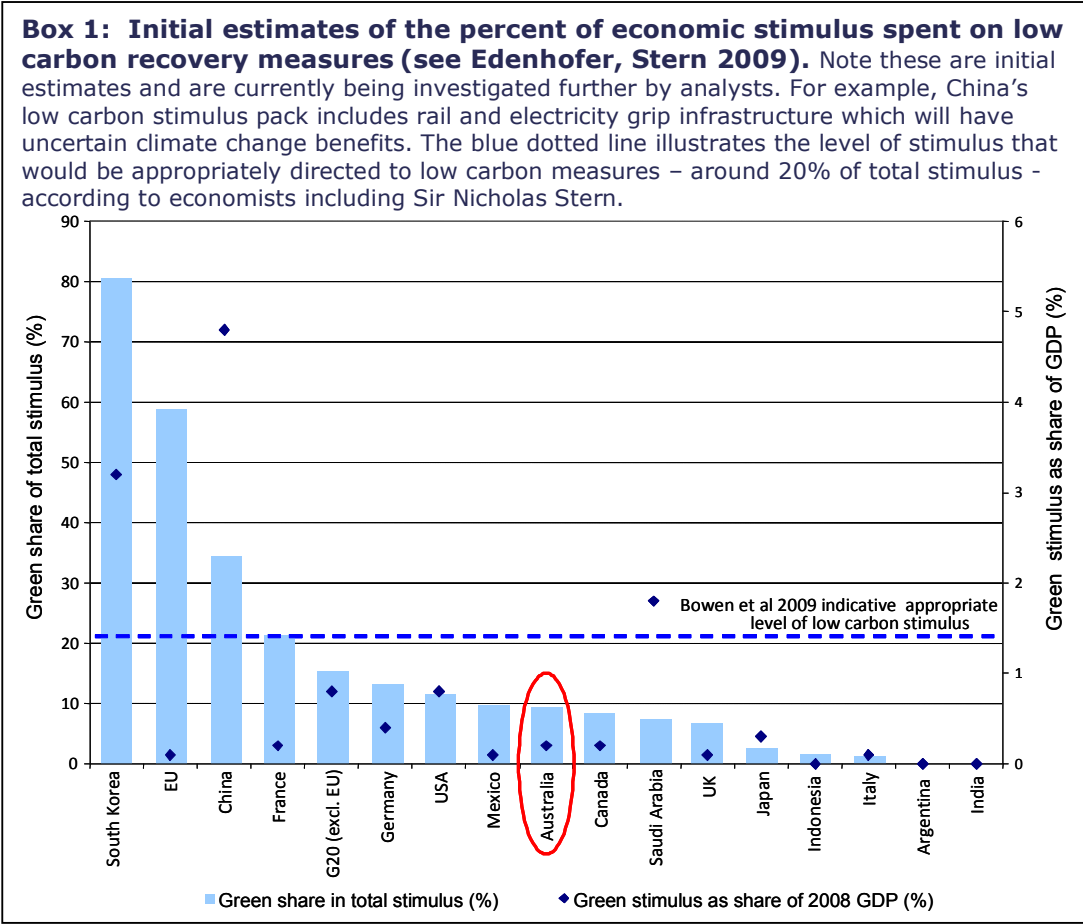
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<sup>1</sup> Commonwealth Treasury (2008), Australia's Low Pollution Future: The Economics of Climate Change Mitigation, Canberra.

<sup>2</sup> Bowen, Fankhauser, Stern, Zenghelis (2009), An outline of the case for a 'green' stimulus, The Grantham Research Institute on Climate Change and the Environment, The Centre for Climate Change Economics and Policy, London, UK

<sup>3</sup> World Economic Forum (2009), The Green Investing: Towards a Clean Energy Infrastructure Report, World Economic Forum, Geneva, Switzerland.

stimulus to low carbon recovery while Australia’s initial stimulus proposal directly committed around 9%.<sup>4</sup> (See Box 1).



The longer and deeper the economic downturn the greater the role of investment incentives as well as longer-term government infrastructure spending to support fundamental shifts towards low-carbon growth compared to short-term stimulus spending.

In this context failure to pass effective legislation this year and delay further action on climate change would be economically irresponsible for four key reasons:

1. The economy will eventually grow out of the recent turmoil and new jobs, investments and economic activity will be generated. This is exactly the time to ensure that these new jobs and investments are in the industries that will have a competitive advantage in a carbon constrained world.

The low carbon jobs and industries of today are the ones that will continue to thrive in the future. Conversely, as we move out of the short-term economic downturn, if investments continue to prop up the highly polluting and highly energy inefficient industries of the past, governments will just compound the future economic cost.

<sup>4</sup> Mabey (2009), Delivering a Sustainable Low Carbon Recovery: Proposals for the G20 London Summit, E3G, London, UK

2. Uncertainty in the face of the Government's response to climate change also makes investment difficult and underscores the importance of the rapid introduction of effective climate change policies. The signals government send to markets at this time will be critical for long-term infrastructure and low carbon investment (see Box 2).

We note the conclusions of the former Government's Task Group on Emission Trading report which concluded, "...waiting until a truly global response emerges before imposing an emissions cap will place costs on Australia by increasing business uncertainty and delaying or losing investment. Already there is evidence that investment in key emissions-intensive industries and energy infrastructure is being deferred."<sup>5</sup>

Modelling for the group indicated that in the electricity sector the cost to consumers from delaying action would be between AUD 1.8 to 3.5 billion to 2017.

3. Failure to promote energy efficiency and fuel and modal switching will expose the economy and vulnerable communities to higher energy costs as the world recovers and demand for oil and other energy commodities increases.
4. Critically, if Australia delays the passing of effective legislation this year it will send a damaging signal to other countries that the current financial crisis is a reason to delay. This will further reduce Australia's ability to influence a global deal that meets the national interest.

The CPRS and the exposure legislation provides a strong framework which has improved on many of the mistakes in other jurisdictions but, as this submission illustrates, the Climate Institute can't support this legislation in its current form. We look to the Government and Senate parties to improve this legislative framework

## Need for complementary measures

In addition to an effective emissions trading scheme, a suite of complementary but mostly interim policies will be needed to implement the transition to a low carbon economy in a timely, low risk and cost effective manner. These include:

1. policies to ensure a broad range of low emission technologies are commercially deployed by 2020;<sup>6</sup>
2. a national energy efficiency strategy;<sup>7</sup>
3. investments in public transport and urban design;
4. the early introduction of additional policy measures targeting emissions from agriculture, and;<sup>8</sup>

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<sup>5</sup> Prime Ministerial Task Group on Emission Trading (2007), Report of the task group on emissions trading, Government of Australia, Canberra.

<sup>6</sup> See The Climate Institute (2008), Making the Switch to Clean Energy, the Climate Institute, Sydney, <http://www.climateinstitute.org.au/images/reports/mtspb.pdf> and MMA (2008), A comparison of emission pathways and policy mixes to achieve major reductions in Australia's electricity sector greenhouse emissions, McLennan Magasanik Associates Pty Ltd, Melbourne, <http://www.climateinstitute.org.au/images/reports/mmagr.pdf>

<sup>7</sup> See The Climate Institute (2008), Australia's National Strategy for Energy Efficiency, the Climate Institute, Sydney, <http://www.climateinstitute.org.au/images/energy%20efficiency%20policy%20paper%20final.pdf>

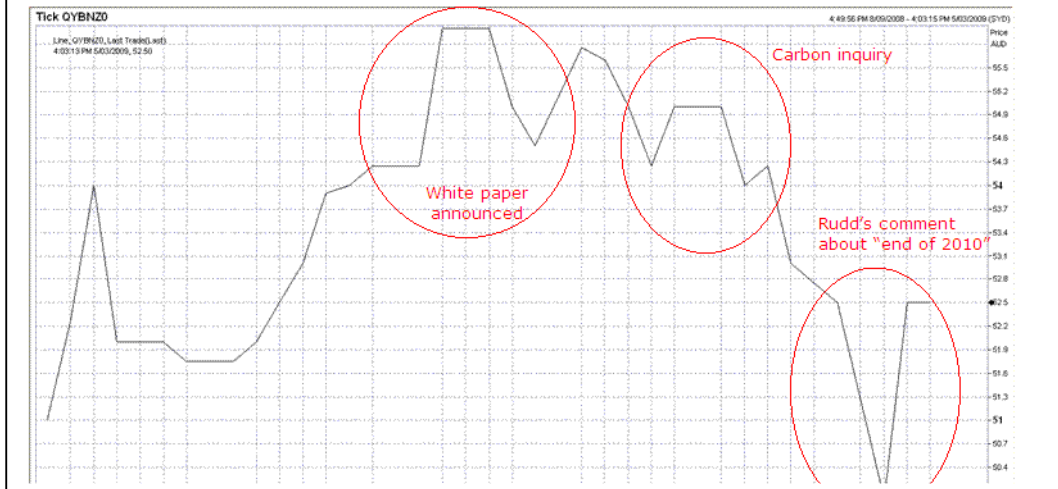
<sup>8</sup> See The Climate Institute (2008), Australia's Carbon Pollution reduction Potential, the Climate Institute, Sydney, <http://www.climateinstitute.org.au/images/carbon%20pollution%20reduction.pdf>

- financial and prudential regulations to enhance reporting of portfolio climate risks and to better reward management of climate change risks and opportunities

**Box 2: Business confidence and government announcements.**

Investments in critical infrastructure are being delayed due to uncertainty about the direction of future climate policy in Australia. This is particularly acute in the electricity sector where delay in investment will drive up electricity prices and may threaten secure electricity supply. Prime Minister Howard's Task Group on Emission Trading concluded, "...waiting until a truly global response emerges before imposing an emissions cap will place costs on Australia by increasing business uncertainty and delaying or losing investment. Already there is evidence that investment in key emissions-intensive industries and energy infrastructure is being deferred" (Prime Ministerial Task Group on Emission Trading 2007). Modelling for the group indicated that in the electricity sector the cost to consumers from delaying action would be between AUD 1.8 to 3.5 billion to 2017.

Government announcements have real impacts on markets and the current political uncertainty around the future of the Commonwealth's Carbon Pollution Reduction Scheme is having an impact on the real economy. The figure below illustrates the impact of Government announcements on forward retail electricity price contacts (for 4<sup>th</sup> quarter 2010) in NSW from the 9<sup>th</sup> of December 2008 to the 5<sup>th</sup> of March 2009. For example, when the Prime Minister slipped in a media interview and suggest the scheme may be delayed by six months the forward price crashed. The price returned to pre-slip up levels a couple of hours later when the PM's office had issued a clarifying statement. Under such volatile conditions investors can not invest in low emission technology.





### 3. BUILDING A GLOBAL AGREEMENT FOR THE NATIONAL INTEREST

The key Objects of the exposure draft legislation are to “support the development of an effective global response to climate change” and reduce “greenhouse gas emissions to between 5% and 15% below 2000 levels by 2020.”

The Government’s CPRS White Paper acknowledges that the 5-15% target range is “*complemented by an unambiguous statement that Australia’s national interest will be best served by a comprehensive global agreement to stabilise atmospheric concentrations of greenhouse gases at around 450 parts per million of carbon dioxide equivalent (ppm CO<sub>2</sub>-e) or lower...*”

However, as the Government notes, the 5-15% target range is linked to a goal of stabilizing atmospheric GHG concentrations at between 550 ppm-e and 510 ppm-e. The Government has also noted that Australia’s fair share towards a 450 ppm-e goal, would include a national target of at least 25% below 1990 levels by 2020.<sup>9</sup>

Achieving a global agreement in the short-term that is consistent with early action towards Australia’s national interest will be challenging (see Box 3). However, it is the Climate Institute’s view **that the chances of achieving an outcome consistent with the national interest will be enhanced if Australia clearly articulates a 2020 emission reduction range in the CPRS that is consistent with our contribution to stabilising concentrations below 450 ppm-e. In the context of a global effort to that target, Australia’s fair share is at least 25 per cent reductions of 1990 emissions by 2020**

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<sup>9</sup> Commonwealth Treasury (2008), Australia’s Low Pollution Future: The Economics of Climate Change Mitigation, Canberra.

**Box 3: Aggregate emission reductions and the national interest**

To date no developed country nation or group has put on the table national 2020 targets that are consistent with meeting Australia's national interest. This raises questions as to whether this bottom up approach to setting targets is in Australia's interest. (In this context it is important to note the USA has yet to have a national debate about what it is prepared to do as part of a global response to climate change and that President Obama's target of reducing emissions to 1990 levels by 2020 is not conditional on action from other countries.)

To meet national interest objectives and as part of its international strategy Australia should propose a science based approach to aggregate emissions outcomes, in particular that:

- > Advanced (or Annex 1) countries adopt a aggregate 2020 target in the minus 25 to 40% range (below 1990 levels) by 2020 as identified by the Intergovernmental Panel on Climate Change for stabilising at around 450 ppm-e .
- > All countries commit to ensuring that global emissions peak no later than 2020.
- > Australia proposes that by Copenhagen advanced country national obligations are then developed to deliver the aggregate target, based on ensuring comparable emission reductions and in accordance with each country's responsibilities and respective capabilities.
- > Australia also signals its willingness to play its proportionate part in meeting the overall advanced country target.

This position would compliment assertive engagement around financing issues within the UNFCCC and other forums such as the G20.

The Government's proposal to defer action consistent with Australia's national interest until after 2020 is extremely risky and economically dangerous. It is highly questionable – economically, scientifically and politically – whether it is possible to achieve stabilisation at 450 ppm-e or lower if national targets consistent with this are deferred until post 2020.

Achieving such an outcome would require very rapid emission reductions post 2020 and have more dramatic economic and social costs than if action had been taken earlier. Recent assessments have suggested that redirecting global emission trajectories onto a 450 ppm-e or lower path post 2020 may not be economically feasible<sup>10</sup> or scientifically possible.

It also might prove ineffective as the capacity of natural carbon sinks of diminishes. This would leave future generations more reliant on the readiness of unproven technologies that have negative emissions (e.g. biomass with carbon capture and storage, industrial air capture with geological storage etc.). Delaying a commitment to a 450 ppm-e pathway would also lock in higher levels of climate change and increase the risk that global tipping points are triggered. There is also significant concern that future policy makers would not feel bound by our decision to pass the burden

<sup>10</sup> Michel den Elzen, Malte Meinshausen, Detlef van Vuuren (2007), Multi-gas emission envelopes to meet greenhouse gas concentration targets: Costs versus certainty of limiting temperature increase, Global Environmental Change 17: 260–280.

to them and be reluctant to close energy related-capital stock and instead opt for a higher stabilisation target, further delay and even higher future impacts.

## Building the flexibility to meet the national interest

The CPRS should complement an international strategy to secure a global agreement in Australia's national interest. As the above discussion illustrates, the current target range included in the Objects of the exposure draft legislation fails in this regard. Moreover, the exposure draft legislation fails to provide sufficient flexibility for Australia to accept a stronger 2020 target if an international agreement is reached that is consistent with the national interest.

**The Climate Institute recommends that CPRS legislation be structured in a way that allows the flexibility for Australia to accept a 2020 target consistent with the national interest in Copenhagen in December 2009. In the context of a global effort to that target, Australia's fair share is at least 25 per cent reductions of 1990 emissions by 2020.**

If necessary, final national 2020 targets could be established post Copenhagen and adjustments to Australia's national target and trajectory beyond 15% below 1990 levels by 2020 could occur upon the approval of a future international agreement on climate change.

**In addition, this target setting and the separate but related scheme cap and gateway setting process (part 2 of the exposure draft legislation) must consider Australia's national interest of stabilising greenhouse gas levels at 450 ppm or lower.** In the exposure draft legislation this consideration is discretionary, giving the Minister the power to ignore the national interest of stabilising concentrations at 450 ppm-e or lower in the CPRS cap and gateway setting process.

Calls from business for a narrow emission reduction range should be treated with care. For example, across this range Treasury modelling indicates carbon prices of between around \$30-\$60/tonne by 2020, and a difference of only \$10/tonne between the CPRS -15 and Garnaut -25 scenarios.<sup>11</sup> Given Australia will likely be a carbon price taker over the medium term, the scope of global action is the principal driver of uncertainty, not domestic decisions about the emissions targets (i.e. due to international trading carbon prices will be increasingly divorced from prices that might be established by a scheme limited to Australia).

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<sup>11</sup> Commonwealth Treasury (2008), Australia's Low Pollution Future: The Economics of Climate Change Mitigation, Canberra.

## 4. DRIVING CARBON PRODUCTIVITY AND TRANSPARENCY

As the Government has stated on many occasions, the CPRS is intended to drive a transition to a low carbon economy. The Climate Institute supports this goal, but we do not believe the scheme's design outlined in the White Paper and the exposure draft legislation will allow this transition to occur in an economically efficient manner. The multi-billion dollar assistance package proposed for Emission Intensive Trade Exposed Industries (EITEIs) is of particular concern.

The Climate Institute accepts that for a small number of industries there may be some justification for limited assistance to avoid 'carbon leakage'.<sup>12</sup> However, decisions regarding assistance for EITEIs should be based on a rational assessment of the veracity of claims regarding carbon leakage. Decisions regarding assistance for EITEIs must also consider the implications for the rest of the economy and for Australia's transition to a low-carbon economy.

On balance it is our view that the proposed assistance for EITEIs is excessive, cannot be justified on carbon leakage grounds, will place an unacceptably high burden on the rest of the economy, and will undermine Australia's transition to a low carbon economy.

### Rationale for EITEIs assistance

Claims of carbon leakage and requests for industry assistance should be carefully examined before handing over billions of dollars annually in free permits to EITEIs.

Treasury modelling undertaken for the CPRS found there to be 'little evidence of carbon leakage.'<sup>13</sup> Treasury found that even under the strongest target assessed (-25%) carbon prices are unlikely to be high enough to force industry to relocate overseas. Indeed, according to Treasury, even without shielding of EITE businesses in Australia there are only minor impacts on the distribution of global production. The result of its modelling led Treasury to conclude that 'fears of carbon leakage... may be overplayed.'<sup>14</sup>

Prior to the release of the CPRS White Paper, The Climate Institute commissioned McLennan Magasanik Associates (MMA) to assess the risk of carbon leakage and the efficiency of proposed assistance measures. Like the Treasury analysis, MMA found that carbon leakage is likely to be partial and claims of industry fleeing offshore have been widely exaggerated.

To illustrate, MMA assessed the risk of carbon leakage in aluminium and LNG industries – two of the loudest voices calling for government handouts. With

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<sup>12</sup> See MMA (2008), Emissions Intensive Trade Exposed Assistance Policy, Report to The Climate Institute, McLennan Magasanik Associates Pty Ltd, Melbourne.

<sup>13</sup> Commonwealth Treasury (2008), Australia's Low Pollution Future: The Economics of Climate Change Mitigation, Canberra.

<sup>14</sup> Commonwealth Treasury (2008), Australia's Low Pollution Future: The Economics of Climate Change Mitigation, Canberra.

respect to the aluminium industry, MMA found that even if production did shift overseas, the risk of carbon leakage is low. In fact, since Australia's aluminium industry is significantly more emissions intensive than other part of the world, moving production offshore may result in a net reduction in emissions.

MMA's analysis of the LNG industry also found little risk of carbon leakage, concluding that "emissions leakage from reduced production in Australia may not occur at all, given that global resources available for development of such facilities are currently limited and that all natural gas resources that are economically exploitable are either being exploited or under development." This is supported by industry's own analysis, which found that applying a carbon price would reduce the internal rate of return of a large-scale natural gas project by less than 1%.<sup>15</sup> With such a marginal impact, it is difficult to believe that introducing the CPRS will signal the end of Australia's LNG industry.

The findings of Treasury, MMA and others raise serious doubts about the veracity of carbon leakage claims put forward by certain companies and industry associations. Yet a close reading of the White Paper and exposure draft legislation suggests that the Government has failed to take these views on board. Indeed, it appears certain that the scale of the EITE assistance outlined in the CPRS White Paper is well beyond what is warranted to prevent carbon leakage.

The Garnaut Climate Change Review proposed a methodology for ensuring support provided to EITE industries is commensurate with the goal of preventing carbon leakage, but the Government has dismissed this approach as unworkable. Yet, even if this is the case, it does not justify the Government's swing so far in the other direction, where the issuance of free permits is likely to exceed the potential effects of the CPRS with respect to carbon leakage.

The proposed EITE assistance package fails to provide a balanced policy response to the risk of carbon leakage. Instead, it amounts to corporate welfare, with little, if any, consideration for mutual responsibility. The Government may argue that this approach will ease the transition for these companies to a carbon-constrained economy. Yet, as outlined below, this comes at the expense of the economy as a whole and is not accompanied by the equivalent support for Australia's future industries.

## Placing a burden on the rest of the economy

The proposed design for the CPRS places no limit on the total number of permits to be given away to EITEIs. If a company increases production, resulting in higher emissions, it will be eligible to claim more free permits. Similarly, if a new EITEI activity comes into existence, it will also be eligible for free permits, expanding the hand out to EITEIs even further.<sup>16</sup>

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<sup>15</sup> Australian Petroleum Production and Exploration Association (2008), Submission to the Carbon Pollution Reduction Green Paper, available at: [www.appea.com.au](http://www.appea.com.au).

<sup>16</sup> It is important to note that the White Paper does propose to reduce the rate of assistance available for EITE activities in line with improvements in 'carbon productivity'. However, while this will reduce the number

According to the Government, around 25% of permits will be given away freely to EITEIs when the CPRS begins in 2010, rising to 'around 45 per cent' of total permits by 2020.<sup>17</sup> If emissions from EITEIs grow faster than expected – something the Government acknowledges is possible – they will receive an even greater share of permits. Furthermore, as detailed below, the share of total permits given to EITEIs will be significantly higher if a stronger national target is adopted.

While the total number of permits available through the CPRS will be reduced over time, the number of free permits available to EITEIs will be allowed to grow. This means there will be fewer and fewer permits available for other sectors of the economy. In other words, as acknowledged by the Government, this shifts 'an ever increasing burden onto the rest of the economy.'<sup>18</sup> Professor Ross Garnaut also warned of this outcome, pointing out that protecting EITEIs 'redistributes the burden of abatement across other parts of the Australian economy'.<sup>19</sup>

As well as transferring billions of dollars from Australian taxpayers to business, providing unlimited free permits to EITEIs means the rest of the economy, including households, will be forced to work harder to reduce emissions.

As illustrated in Figure 1, with the Government's minus 5% target total emissions from EITEIs will be able to increase to 20 per cent above 2000 levels. To accommodate this growth households and non-EITEIs will have to cut their emissions by 18% below 2000 levels.

This situation worsens as the target is strengthened. If a 15% target were adopted, non-EITEIs and households would be required to cut their emissions by around 32% below 2000 levels to accommodate a 20% increase in emissions from EITEIs (Figure 2).

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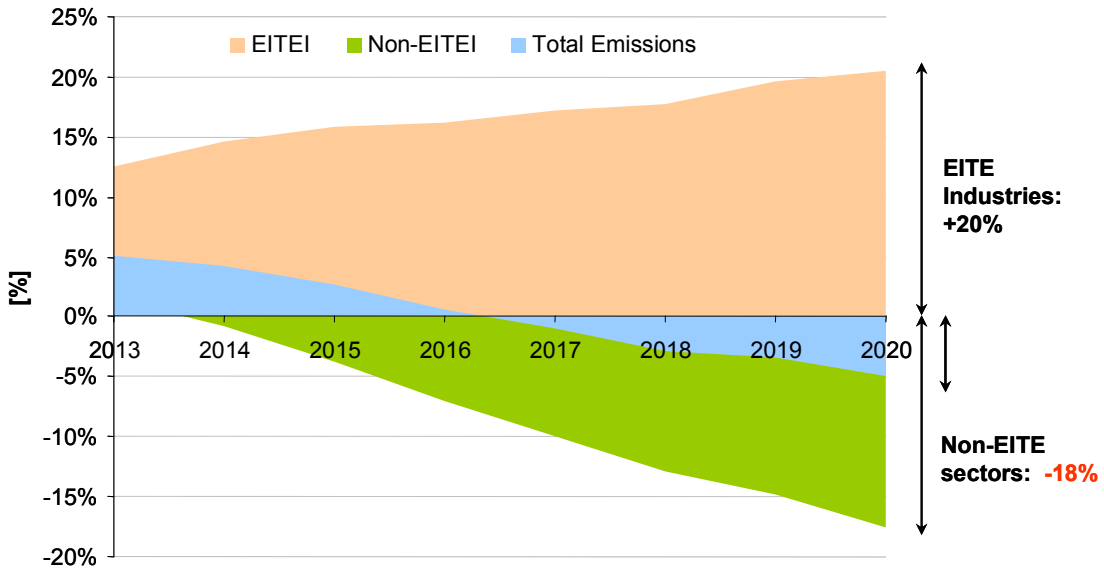
of permits available per unit of output, it does not limit the total number of permits available to EITE industries.

<sup>17</sup> This is based on the assumption of EITE sector growth of 3% per annum.

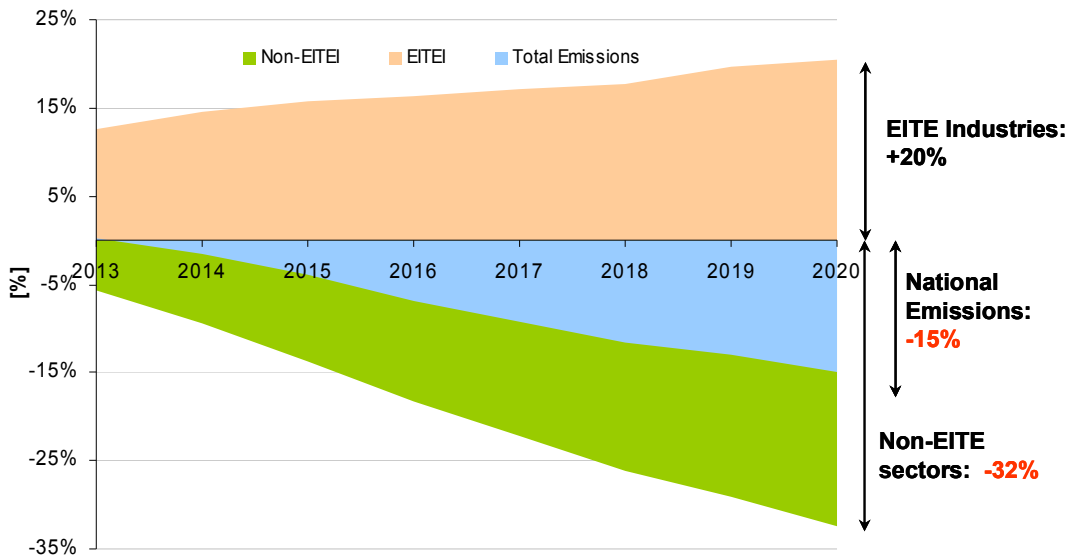
<sup>18</sup> Department of Climate Change (2008), Carbon Pollution Reduction Scheme Green Paper, [www.climatechange.gov.au](http://www.climatechange.gov.au), p.28.

<sup>19</sup> Excerpt from Garnaut Climate Change Review (2008), Final Report, Cambridge University Press, Melbourne, p.297

**Figure 1: Trend in emissions levels from the EITEIs compared to Non-EITEIs under the CPRS-5 scenario**



**Figure 2: Trend in emissions levels from the EITEIs compared to Non-EITEIs under the CPRS-15 scenario**



Shifting an ever increasing burden on to other parts of the economy to reduce emissions is unlikely to be institutionally feasible in the long run. The IPCC notes that the institutional feasibility – the extent to which a policy instrument is likely to be viewed as legitimate, gain acceptance, adopted and implemented – is a key criteria for effective policy development.<sup>20</sup> Beyond the need to balance assistance to industry with the impact on the broader

<sup>20</sup> Gupta, Tirpak, Burger et al (2007), “Policies, Instruments and Co-operative Arrangements” in: IPCC (2007), Climate Change 2007: Mitigation. Contribution of Working Group III to the Fourth Assessment Report of the Intergovernmental Panel on Climate Change, Cambridge University Press, Cambridge.

economy, recent market research suggests that the institutional support for emissions trading will be undermined if government is seen to “giving too many handouts to industry”.

### Wealth transfer restricts ability to invest in the future

According to the Government, giving away free permits to EITEIs will cost Australian taxpayers around \$2.9 billion in the 2010-11 financial year.<sup>21</sup> Based on Treasury data, The Climate Institute forecasts that this annual wealth transfer to rise to around \$5.8 billion by 2015 and \$8.6 billion in 2020. This adds up to more than \$58 billion being paid out to EITEIs between 2010 and 2020.<sup>22</sup>

Every free permit given to EITE industries is one less permit available to auction to the highest bidder. This creates a hole in the CPRS revenue pool and constitutes a massive wealth transfer from Australian taxpayers to the big polluters.

Full auctioning of emission permits would generate a multi-billion dollar revenue stream for the Government. High priority for revenue from this emissions trading dividend should be given to supporting vulnerable low income communities and funding further development and deployment of new and existing low emission technologies. Furthermore, this potential revenue stream should be used to assist Australia’s developing country neighbours to reduce emissions and adapt to climate change. This is critically important as Australia’s long-term prosperity will depend on the continued growth of countries in our region.

As shown in Figure 3, at 2% funding for energy efficiency and low emission technologies announced in the White Paper is considerably less than the at least 32% of potential CPRS revenue in 2010 which will flow to big polluters.<sup>23</sup> The ability of the Government to allocate more funds to low-emission technologies and energy efficiency is constrained by the fact that there is no limit on the number of free permits that will go to EITEIs. Indeed, if the Government were to promise more funding for these climate change solutions, as is clearly needed, there is unlikely to be funding available from the auction of carbon pollution permits.

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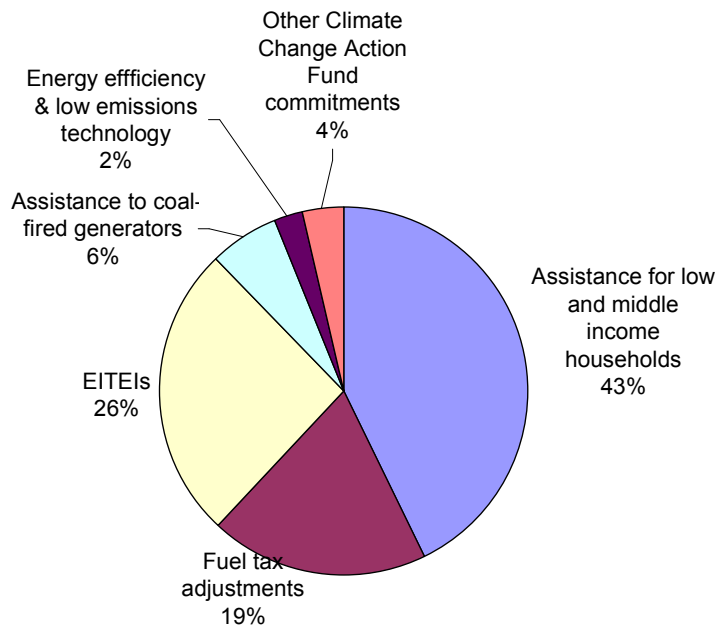
<sup>21</sup> Commonwealth of Australia (2009), Updated Economic and Fiscal Outlook, February 2009, published online at: [http://www.budget.gov.au/2008-09/content/uefo/download/Combined\\_UEFO.pdf](http://www.budget.gov.au/2008-09/content/uefo/download/Combined_UEFO.pdf).

<sup>22</sup> These figures are in 2005 dollars

<sup>23</sup> This figure includes the share of permits that will be allocated to electricity generators



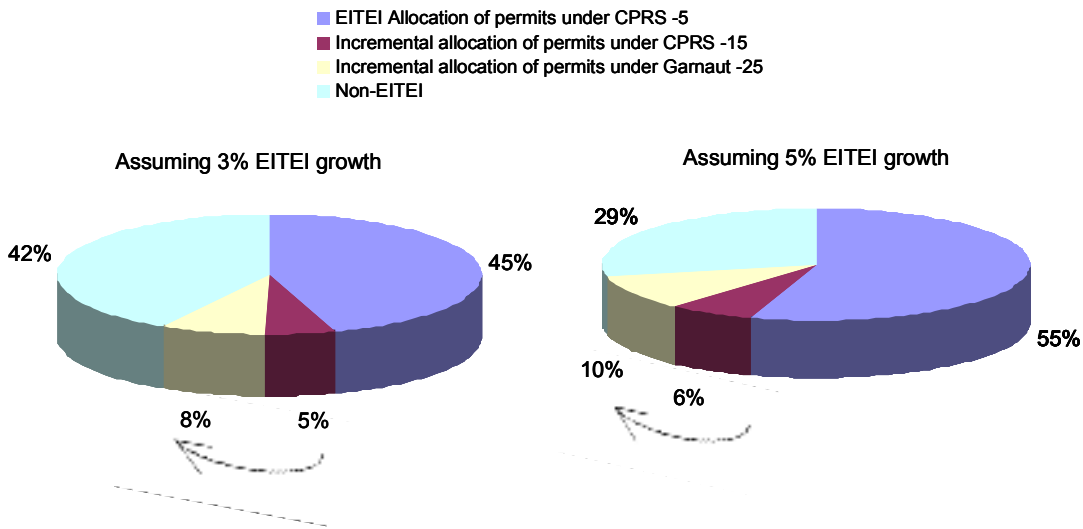
**Figure 3: Allocation of permit revenue in 2010**



The situation worsens if emissions from EITEIs grow by more than expected. This risk is highlighted in the White Paper, which acknowledges if emissions from the EITEIs grow at 5 per cent each year the allocation of free permits to these businesses will balloon to around 55 per cent of total permits in 2020. This would erode the permit revenue available for supporting low income households and investing in low-carbon solutions. If this were to occur the Government has declared that Australian taxpayers would bear the budgetary risk. Using Treasury data, The Climate Institute estimates the budgetary risk to be in the order of \$1.9 billion in 2020 under the CPRS-5 scenario.

The CPRS permit revenue stream would be depleted even further if the Government were to adopt a stronger target for national emissions, as part of a global agreement. As Figure 4 shows, in the absence of a limit on assistance for EITEIs assistance, the share of total permits given to EITEIs increases to half of total permits if a 15% target is adopted and 58% under a 25% target. If EITEIs grow at the upper end of the Government's forecast, the proportion of free permits increases to 61% under the 15% target and 71% under the 25% target.

**Figure 4: Comparison of Permit Allocation in 2020 under the 3% and 5% EITEI growth scenarios**



While there may be a justification for some limited assistance to strongly affected industries, revenue raised from the auction of carbon pollution permits also provides a golden opportunity to invest in climate change solutions. Previous analysis prepared by The Climate Institute has shown that shifting to a low carbon economy will require a multi-billion dollar investment over the coming decade.<sup>24</sup> The bulk of this will come from the private sector, but the Government also has an important role to play, particularly in investing in research, development and deployment of new technologies, as well as funding energy efficiency projects. This point was made by the Garnaut Climate Review, which argued in favour of the Government funds being used to address market failures that prevent the large scale of uptake of low emission technologies and energy efficiency solutions, to both households and businesses.<sup>25</sup>

Using revenue from the auction of carbon pollution permits for low emission technologies and energy efficiency is not just about reducing greenhouse gas emissions. Well targeted government investments can be used to stimulate the economy during a time of widespread economic malaise, and underwrite Australia's future economic competitiveness in a carbon constrained world. In contrast, transferring wealth to a narrow band of big polluting industries, while requiring little in return, risks locking Australia into decades of carbon-intensive economic activity. Not only does this weaken our potential to compete in emerging low-carbon markets, it raises the long-term costs of dealing with climate change.<sup>26</sup> To borrow a phrase from the Prime Minister, it represents a "triumph of short-termism" and the expense of long-term, sustainable economic growth.

<sup>24</sup> The Climate Institute (2008), *Clearing the Air: Clean energy investments to power a low carbon future – and the myths polluters use to stall progress*, Sydney, Available from: [www.climateinstitute.org.au](http://www.climateinstitute.org.au).

<sup>25</sup> Garnaut Climate Change Review (2008) Final Report, Cambridge University Press, Melbourne.

<sup>26</sup> The Climate Institute (2008), *Making the Switch to Clean Energy*, Sydney, available from: [www.climateinstitute.org.au](http://www.climateinstitute.org.au).

**The Climate Institute recommends that the CPRS legislation include a commitment to move to full auctioning of carbon pollution permits, with revenue to be channelled towards the following priorities: vulnerable low income communities; research, development and deployment of clean technologies; and support for adaptation and mitigation in developing countries.**

### Inadequate governance and review arrangements

The Government proposes to review assistance to EITEs once every five years, or at another date requested by the Minister for Climate Change and Water. This is backed up by an assurance to industry that at least five years notice will be given before changes to assistance are made. In effect, this could commit the government to a wealth transfer to EITEs for the first 10 years of the scheme, with no changes before 2020.

The Government contends that the EITE assistance package is intended to shield these sectors of the economy until there are similar policy mechanisms in place amongst Australia's trading partners. This, it is argued, will limit the likelihood and extent of carbon leakage. However, a commitment to EITE assistance package for up to 10 years makes it difficult for the Government to respond to developments in international climate policy. In effect this means the wealth transfer to EITEs could continue despite the risk of carbon leakage being removed.

**The CPRS legislation should include a commitment to review, recalibrate and ultimately remove the EITEs assistance as soon as a new global climate agreement enters into force and trading partners introduce domestic policies that result in direct or indirect carbon prices.**

The international community is in the midst of negotiations aimed at producing a new multilateral agreement of climate change by the end of 2009. Australia needs to ensure its domestic climate change laws and policies are flexible enough to respond to the changing international landscape. Committing to an expensive EITE assistance package prior to the outcome of these negotiations is not justified.

EITE assistance package must also take into account the degree of effort being made by these businesses to shift to low-carbon means of production. Ongoing eligibility for the free permits should be conditional on EITEs taking serious steps to cut emissions, and these efforts showing real results. If businesses fail to show real progress they should no longer be eligible for assistance.

### Building confidence, increasing transparency and avoiding unnecessary wealth transfers

The Climate Institute strongly supports reducing assistance to EITEs over time to avoid shifting an ever increasing burden onto the rest of the economy. In the interim, transitional assistance must be geared towards

driving the deployment of world's best practice low emission technology and energy efficiency.

To build community confidence, increase transparency and avoid transferring large amounts of wealth from the public to the private sector the Government should:

1. As part of a package to build community confidence, increase transparency and avoid transferring large amounts of wealth from the public to the private sector, the Government should increase the default carbon productivity improvements for EITEIs assistance to at least 4% per annum. It could also place a cap on the growth of free permits. (to be more consistent with the Green Paper, and the general view on phased international action outlined in the Treasury modelling). This would free up permit revenue to direct towards energy efficiency, low emission technology development and deployment in geothermal and concentrated solar and developing country assistance.
2. Place a trigger in CPRS legislation to review EITEIs assistance as soon as any new international agreement is negotiated, with changes flowing from the review immediately where this involves no material net disadvantage (contingent on the agreement entering into force).
3. Empower the Productivity Commission, or similar organisation, to annually report to the Parliament on real and shadow carbon prices in competitor countries.
4. Tie assistance to a requirement for recipients to prepare and publically report annual and externally audited statements on abatement opportunities. For example, by strengthening the Energy Efficiency Opportunities program including through: extending to greenhouse gas emission abatement opportunities for those receiving EITEI assistance, stronger public reporting requirements on energy efficiency opportunities with longer paybacks; and greater external auditing. Mandatory uptake of energy efficiency opportunities should be foreshadowed as a future option, pending a full evaluation of the EEO program.

## ANNEX 1: CRITIQUE OF THE BASELINE-AND-CREDIT MODEL

There have been calls from some quarters for a re-think on the design of Australia's emissions trading scheme. One alternative that has received some attention is the "baseline-and-credit" model.

The Climate Institute asked McLennan Magasanik Associates (MMA) to compare the baseline-and-credit model with the cap-and-trade model, which is favoured by the Government. MMA's findings are presented below:

Under a cap-and-trade system, an overall emissions cap is set to achieve emissions reductions. Emissions permits are auctioned or provided to participants based on an emissions reduction target. In a cap-and-trade system the restricted supply of permits creates scarcity and combined with trading of permits among participants creates a price for carbon and thereby drives liable parties to seek abatement opportunities that cost less than the permits. In other words, producers of goods that use processes that emit carbon have an incentive to find lower emission processes to minimise their permit liabilities and thereby reduce emissions. At the same time the price of products with embodied carbon rises relative to other goods, creating a demand side response that also acts to reduce emissions. In other words, consumers of goods that are produced using processes that emit carbon face higher prices and have an incentive to spend their money on less emissions intensive goods, thereby reducing emissions in the economy.

Under a baseline-and-credit scheme, an emissions intensity is set for emitting activities against a baseline (which can be business as usual or some proportion thereof) and credits are created for activities that achieve emissions intensities below the baseline and activities that have emissions intensities above the baseline have to buy such credits. The ability to generate credits from emissions reductions relative to baseline and the pressure to avoid having to buy permits for emissions in excess of the baseline provide incentives for participants to find lower emission production processes.

Some commentators have argued that a baseline-and-credit system has advantages over a cap-and-trade scheme as it reduce to pass on of costs especially for electricity generation and also allows other trade exposed energy intensive activities to be better protected.

Both schemes are market based instruments and therefore are likely to be equally efficient. The problems come when applying the schemes in practise.

### General comments

- Under a baseline-and-credit scheme, consumers do not face any incentive to reduce their demand for emissions intensive goods. Baseline-and-credit schemes do not necessarily penalise emissions intensive activities and goods, thereby muting the incentive to consumers to buy less emissions intensive good or undertake less emission intensive activities (e.g. there is no reward for reducing the

number of kilometres travelled in a car). Perversely, to the extent that less emission intensive activities are subsidised, there may be a rebound effect so that more of that activity is undertaken and overall emissions from that activity increases.

- Administrative costs under a base line and credit scheme are likely to be higher as these schemes are more complex to administer. Under a cap-and-trade, a cap is set and emissions are monitored against this cap. Under a baseline-and-credit system, a baseline has to be set for each emitting activity, usually based on historical emission and production rates. This means that the administrator has to establish a base line for each activity at each facility (generating plant, mine and industrial plant). Many of these facilities would not even have historical data to enable a proper base line to be set, so a theoretical base line is established based on formulas. This is complicated by the fact that emission intensities differ widely even amongst plants in the same industry (for example, methane emissions from coal mines differ widely from mine to mine). The Federal Government proposes to include around 1000 of the highest polluting sites. The cost of setting base lines for each of these sites would be very high, which would only increase once all sites are included. The costs of setting and verifying emission savings from each abatement activity would also be high.
- Baseline-and-credit systems create greater uncertainty in achieving given targets for emission reductions. This is because the baseline-and-credit system is based on emission intensity not emissions (as is a cap-and-trade scheme). Therefore in any one year there is no certainty that a target is met (say if economic growth increases more than expected). This may require catch up later through resetting baselines, creating uncertainty for market participants through continually changing scheme parameters. This uncertainty also compounds the risk of meeting internationally set targets. There would be an additional liability on government/taxpayers in terms of buying international permits and again further subsidising emitting activities. This would also increase risks of institutional failure as governments may chose to renege on international obligations instead of complying with international commitments. This would weaken global action as has been seen in the case of Canada.
- Baseline-and-credit schemes can be more open to gaming, reducing its effectiveness in achieving a given target. This arises through the process of setting the baselines, which aims to encourage people to reduce emissions. But given the superior knowledge of each plant owner over their own processes, they can easily manipulate the calculation of the base line to levels that are higher than the real emission intensity, thus avoiding any impost. The plant can then claim an efficiency improvement against its baseline and be rewarded with certificates for improving its notional emission intensity as calculated against its baselines. The alleged savings from abatement activities is also open to gaming, as witnessed by the level of certificates awarded to demand side activities (mainly more efficient light globes) under the NSW NRGAS facilities, even though the activities are not necessarily carried out. Verifying emission intensity level and abatement activity adds to the administrative costs of the scheme.

## Specific comments

- It is claimed that baseline-and-credit schemes can lead to lower wholesale prices. An example is the NSW GGAS, where emission abatement activities are effectively subsidising low emission activities in electricity generation. Whilst this subsidy effect can occur in the wholesale market, someone has to pay for the certificates that generate the subsidy. There is no free lunch. In the electricity market, the cost is passed on to at the retail end. So higher costs are faced by consumer, not just in the wholesale market.
- For industries where there is no transparent wholesale markets, the cost of purchasing certificates would be felt directly. A coal miner would still need to pass on as much of the cost of reducing fugitive emissions from its mine in the same way as it would under a cap-and-trade scheme. Abating emissions is costly and this cost has to be borne by someone.
- Costs may even be higher still if significant sorting occurs to the extent that additional certificates are required to be created to achieve an emission target. Since high emitting plant are not necessarily forced to be shut down (or as quickly as they may under a cap-and-trade scheme), higher cost options for abatement may be required.