

Speech to the 2014 CFO Strategy Summit:

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“Managing business in the context of policy uncertainty: a decade of climate policy acrobatics”

Good morning everyone. Today I’m here to talk to you about climate policy: not what temperatures are doing, but what governments may choose to do about it. It’s a useful case study for how business deals with uncertainty and the limits of knowledge; but despite exhaustion after endless talkfests and doorstopper reports, it also matters to many businesses in its own right.

Why it matters

Climate change itself presents risks to businesses – for instance those that are exposed to markets for water and agricultural products, or which rely on critical infrastructure located on coastlines, or whose employees are vulnerable to heat stress or disruption of transport systems during extreme weather events.

Despite a lot of uncertainty over how future emissions will track and how exactly the climate will respond, these risks are well worth thinking about. Ai Group has helped vulnerable member businesses

to assess the risks to their specific sites and identify realistic options to manage those risks.

But the risks and uncertainty I want to focus on today relate to policy. Governments of all stripes say they want to avoid dangerous climate change. The steps they take to achieve that goal can have a big impact on business: we've just come through a period when climate policy accounted for at least 15% of the price of electricity to large industrials. The value of major assets like power stations and electricity networks can be greatly affected by what climate policy does to their cost structure and demand.

The clearest avenue for Australian climate policy to impact business is via the energy sector; electricity is the most emissions intensive product that businesses consume most often. New low-emissions electricity generation is somewhat more expensive than new coal, and much more expensive than existing assets. Whether climate policy prices emissions, or subsidises abatement, or retires old assets, it ultimately has to deal with energy and is likely to push up costs.

Not every business is significantly exposed to energy prices; our surveys show that in 2011 nearly half of all businesses spent the equivalent of less than 1% of turnover on energy. But there is

another avenue of impact that is increasingly topical and will touch an even larger set of businesses.

That is the impact of other countries' climate policies on Australia. Traditionally we've tended to concentrate on analysing the impact of our own governments' policies. There's often an assumption that the most conservative approach is to consider how high our costs will be if we act and other countries do nothing. But how other nations respond to climate change will impact their patterns of growth and the demand for emissions intensive goods and services. When Warwick McKibbin modelled the impact of the Copenhagen emissions pledges, they found that Australia experienced the greatest loss of GDP of any economy, largely because other countries' pledges lowered prices and volumes for exports like coal and iron ore.

China's recent commitment to peak its emissions by 2030 implies just this kind of shift, affecting many different Australian businesses, for good and ill, as our trade ties grow closer.

From chaos to consensus

So this climate stuff is not just for the policy wonks – it can change the prospects for your business. What should you be planning for?

The answer, alas, is not as clear as it should be.

Public policy first grappled with climate change as far back as 1965, when a pollution report from Lyndon Johnson's science advisors included a long chapter on the risks posed by the rise in carbon dioxide levels that was already evident. The advisers suggested counteracting harmful warming by spreading millions of tonnes of reflective particles across the oceans to raise the Earth's albedo. That sounds very 60s – albeit more 'Dr No' than LBJ. But similar geo-engineering concepts remain a live debate today.

It was in the 1980s that governments worldwide began to take the view that the accumulation of greenhouse gases in the atmosphere should stop, and to debate how to bring this about.

The Intergovernmental Panel on Climate Change was formed in 1988 to advise governments on the science; it has issued five comprehensive assessments since then, the latest coming earlier this month.

In 1988 the Toronto conference on climate change proposed targets to reduce global emissions by 20% below 1988 levels by 2005, and the following year Environment Minister Graham Richardson proposed to Cabinet that Australia adopt that target. Richo was knocked back at first, but in 1990 the Hawke Government took on

the 20% target – on the proviso that it would do nothing with any net costs to meet it until other countries did likewise.

In 1992 negotiators concluded the first global climate treaty, the UN Framework Convention on Climate Change, with all major economies rapidly signing on. It established an agreed global goal to avoid dangerous climate change and principles for dividing the effort, but left details about targets and obligations for later.

The Howard Government carried on Australia's role in the followup negotiations, winning a deal at Kyoto in 1997 that allowed Australia to increase emissions to 8% above 1990 levels. Australia decided not to ratify Kyoto because binding targets only applied to wealthy industrialised countries, rather than obvious sources of major new emissions growth like China. But the Government thought hard about how to meet the targets anyway – because it expected emissions to rise by even more without new policy.

And that kicked off the gyrations in Australian climate policy that have grown ever wilder in recent years. The Howard Government's primary approach was to use relatively small scale and low cost sectoral policies. In 2000 they brought in modest voluntary programs to encourage emissions reduction in industry, a rebate for household solar and a Mandatory Renewable Energy Target that aimed to increase the renewables share of electricity by 2

percentage points by 2010. The 1999 Environment Protection and Biodiversity Conservation Act started a gradual clampdown on land clearing.

But the Howard Government also initiated a public consultation on a potential emissions trading scheme in 1999, releasing four detailed papers on key design issues. That initiative appeared to go nowhere at the time, but in 2002 the Parer Review of Australia's energy markets recommended an ETS to replace all existing greenhouse policies. In 2003 a fully fledged proposal for emissions trading was seriously considered inside the Government, though ultimately rejected.

Three years later the Prime Minister commissioned a task group led by his chief public servant, Peter Shergold, to consider whether Australia should adopt an ETS, and if so how it should be designed. Working with strong industry involvement, the task group recommended a broad-based, internationally linked ETS – and Howard adopted it as a policy for the 2007 election, to be up and running by 2012 at the latest.

What had changed? The science of climate change had grown more compelling, and public opinion on the urgency of action had shifted. But the limits and costs of current policies were also becoming clearer.

Climate policies were proliferating across Australia as governments of all stripes tried to do their bit. Some were major initiatives, like the 2003 NSW Greenhouse Gas Abatement Scheme, the world's first mandatory greenhouse trading scheme. The 2005 Queensland Gas Scheme mandated 13% of electricity supply to come from lower-emitting gas-fired generators. The 2006 Victorian Renewable Energy Target went over the top of the federal scheme. Environmental regulators started talking about greenhouse conditions for certain major project approvals. The States launched their own project in 2006 to design a national ETS of their own to bypass the Commonwealth.

These big fish were vastly outnumbered by policy barnacles – ever increasing quantities of small announceable policies for minor spending or modest regulation: standards and rebates and pilots and projects. By early 2009, when the Productivity Commission totted up all these policies, there were 244 emissions reduction policies across Australia.

That was clearly a mess, with wildly differing abatement costs and rules from state to state and measure to measure. Some were clearly underperforming; the Commonwealth's Greenhouse Gas Abatement Program was meant to spend \$400 million on abatement projects, but most of them fell over and it only achieved 30% of its target.

Other policies were reaching their limits. Clamping down on land clearing got Australia to its Kyoto target at low cost – except to irate farmers - even while energy emissions went up and up. But after reducing deforestation by nearly 80%, deeper targets would need something more.

Throughout this period, business would have been hard pressed to know what to plan for. In the mid to late 90s electricity assets were starting to be privatised, and major industries were investing to increase their output and ensure future competitiveness. If governments had significant plans for future climate policy, those would make a difference to asset values and the shape and location of investment. Clarity would have been useful; but governments blew hot and cold.

Both sides of politics talked about future reductions, but with stringent conditions about international action. Both sides considered broad-based market mechanisms, but timelines and design features were never clear enough to plan on – and meanwhile the policy barnacles were accumulating.

From consensus back to chaos

By 2007 it looked like policy chaos had turned into consensus. Both the Coalition and the ALP took similar ETS proposals to the election

that year: broad coverage to ensure even incentives for efficient abatement; international linkage to ensure national costs were minimised; and strong measures to maintain trade competitiveness, especially among emissions intensive industries. There might be winners and losers, but the rules would soon be clear.

It didn't work out that way. The new Rudd Government renamed the ETS to the Carbon Pollution Reduction Scheme, development of which proved as convoluted as the shift in terminology. The scheme went through four major iterations between 2008 and early 2010, culminating in a package negotiated with the Coalition that would have greatly eased the introduction of the scheme, particularly for smaller businesses.

Yet by that time public and business understanding of the scheme was probably lower than it had been before it was proposed; full throated support for the specifics was hard to find; and the Coalition had moved firmly away from emissions trading. In April 2010, when the Rudd Government put the CPRS off til at least 2013, the policy seemed to be dead.

Both sides remained committed to the unconditional 2020 emissions targets proclaimed by Rudd; but there the consensus ended.

Business started to try to get its head around the new alternatives:

citizens' assemblies and regulation from the ALP, and Direct Action from the Coalition.

But emissions trading clawed its way out of the grave just five months later following the narrow re-election of the Gillard Government. A multi party policy committee started meeting in September 2010 to develop options for pricing carbon. The scheme eventually unveiled in July 2011 looked much like the old CPRS in most respects – but it was saddled with a three year introductory period of high fixed carbon prices – the 'carbon tax'. Those prices were based on projections of future international carbon prices. The tax was locked in just as overseas carbon prices started to plunge, driven by strong supply and weak demand.

The carbon tax only ran for two full years, but still managed to go through three major phases:

- In the original plan, once the tax gave way to trading in 2015, a floor price was meant to guarantee that carbon prices could not fall so far as to undermine investments.
- That proved unattractively complex to implement. So in August 2012 the Government junked the floor price and negotiated to link the scheme with Europe's much bigger ETS instead.

- Then once Rudd returned as Prime Minister, the policy became to ‘terminate’ the tax and move within a year to an EU-linked ETS.

Whatever their merits, each of these changes radically altered the prices that industry should expect, whether immediately or over the medium term. A price set by domestic factors is very different to a price set by European economic and political conditions. This sort of change plays havoc with investment cases and hedging strategies – if it is taken seriously. But increasingly through 2012 and 2013, observable markets were pricing in the likelihood that the Gillard scheme would be repealed by an incoming Coalition Government, which had a very different proposal.

Direct Action and next steps

Direct Action was designed to be clearly distinct from carbon pricing: no economy wide price signal, but a call to the market to offer abatement, to be purchased by government at low cost through reverse auctions. A system of penalties for excessive emissions would safeguard overall performance.

The detail of the policy received a lot less attention from all quarters than the more immediate argument over the costs and fate of carbon pricing. Only once the Abbott Government finally achieved

its ambition to 'axe the tax' did Direct Action come fully into the spotlight.

At that point it looked like the policy might go no further. The Government lacked the numbers to pass enabling legislation, with the Opposition and some crossbenchers implacably opposed – albeit for different reasons – and a mass of conflicting demands from the remainder. Many people were taken by surprise when the scheme passed last month, an outcome very much to the credit of Minister Greg Hunt and Senator Nick Xenophon. The amendments achieved by Xenophon make participation in the purchasing scheme more commercially viable, with longer contracts on offer. They reinforce the penalty side of the scheme. But they leave some major questions to be settled later.

The baselines for penalising excessive emissions will be determined late next year. This potentially makes a big financial difference to costs at existing facilities and new builds – particularly in the longer term.

Whether abatement suppliers can get contracts longer than seven years will depend on regulatory reviews that may not happen for many years. That could make a big difference to the land sector and the power sector.

The Government will almost certainly need to revisit its decision not to include a reserve of low-cost international carbon credits in the policy. That would insure against the possibility that the current targets are not met or need to be deepened.

The big questions are familiar. Will it survive? And what will it look like in the longer term? The Opposition appears committed to replacing Direct Action with a revived ETS whenever it next takes office.

And on its own terms, Direct Action is currently just a policy to 2020. Beyond that point the evolution of the scheme is up for debate – particularly the relative roles of government purchasing versus the penalty mechanism for driving abatement. Next year the Government currently plans to kick off no less than five reviews of these issues: two of its own, on the future of Direct Action and the new emissions targets it may offer at the Paris climate conference; and three commissioned from the independent Climate Change Authority as the price of the Palmer United Party's support for Direct Action. The Authority will be looking at targets, emissions trading and the policies needed after Paris.

So there is plenty of work to be done; but the future policy framework remains uncertain.

Conclusion and lessons

Over the past decade Australian climate policy has gone from chaos to consensus and back again. At last count three Prime Ministers and two Opposition Leaders had lost their jobs over the issue.

Carbon pricing has been proposed, abandoned, revived, shelved, resurrected, transformed, terminated and axed – and it's still part of the conversation. Direct Action has beaten the odds and passed into law, but remains a work in progress.

Any investments made on the basis of climate policy during this period will have seen fundamental conditions and expectations change many times over. The only investments that are sure to have been boosted by Australian climate policy are probably Travacalm for spinning heads and Domestos for washing blood off party room floors.

There are some lessons in all this.

Certainty about public policy is as important as the quality of that policy. The efforts of the Rudd and Gillard Governments to keep improving their schemes made planning very difficult, whether or not the improvements were a good idea in themselves. This is particularly important where a big part of the point is to influence

decisions about extremely long lived assets, like power plants, smelters and refineries.

Projections are not prophecy. As Yogi Berra said, ‘predictions are hard – especially about the future.’ Educated guesses about things like future carbon prices have a place. But too often we’ve forgotten that they are limited, tentative guideposts. Surprises like the plunge in global carbon prices, the unprecedented drop in electricity demand, or the rapid reduction in solar panel prices should encourage all of us to consider how robust our plans are to different assumptions.

Politics abhors a vacuum. The Howard Government’s initial preference for a light touch on climate policy helped create an opening that the States were eager to fill. The result was a deluge of policies, many of which were not a big deal in themselves, but which collectively created huge waste, contradiction and confusion. A light touch may not last long.

Sometimes the best decision is to defer a decision. When policy is this unsettled and the facts on the ground are so fast moving, it may be best to look before you leap. In 2008 it looked like gas was the big winner out of climate policy – the best combination of low cost and low emissions to meet continually rising industrial demand for heat and power under a carbon price. Now the demand has gone,

the carbon price has gone, and gas fired generation and co-generation are shutting down in the face of sky-high gas prices. But building new coal-fired plants would be a big risk even if the demand for them were there, since future turns of the policy Wheel of Fortune could easily render them unprofitable. Sweating existing assets and improving energy efficiency is much less exciting for the politicians than a bold leap into the unknown. But when operating under such deep uncertainty it is a much better bet.

It may be that instability is increasing in Australian politics. Certainly we've seen public opinion swing harder and faster at many recent elections, producing rapid reversals and complex parliaments. That will impact a lot of issues that impact business, not just climate. Business can do a lot to manage uncertainty. We can get by for a while. But ultimately the absence of a stable policy framework will mean unnecessary costs and regrettable decisions. All sides of politics should aim higher.

Thank you.

[The following questions have been provided to the audience to consider:

- What areas of public policy are crucial to your business; how settled are they; and how robust are your plans to fundamental

change in those areas? For instance land use rules for construction and development, or water regulation and pricing for agriculture.

- Australian climate policy may impact businesses' costs, particularly for energy, while policies overseas may affect the prices and volumes of key exports. How is your business exposed to each?
- How does your business deal with policy uncertainty?
- What are the characteristics of a 'bankable' public policy – one you would invest on the basis of?]