

## **Climate Change Authority Caps and Targets Review – Issues Paper**

### **Submission from the Australian Industry Group**

#### **1. Summary**

The imposition of an obligation to acquire and acquit emissions permits for all emissions puts a significant burden on liable businesses. Under current legislation, regulations and policy, and given a plausible range of projections for domestic and international market conditions, the choice of caps and targets has a limited impact on that burden. Any reduction in practical access to international abatement would fundamentally change this situation.

Given the severe pressures facing trade exposed industry, Ai Group strongly urges the Authority to avoid the choice of any cap or target that would result in an increase in Australian carbon prices above international levels.

We also urge the Authority to ensure that its recommendations leave adequate room for the continuation of the Jobs and Competitiveness Program for as long as it may be needed, taking into account uncertainty about future production levels in trade exposed industries.

#### **2. About Ai Group**

The Australian Industry Group (Ai Group) is a peak industry association in Australia which along with its affiliates represents the interests of more than 60,000 businesses in an expanding range of sectors including: manufacturing; engineering; construction; automotive; food; transport; information technology; telecommunications; call centres; labour hire; printing; defence; mining equipment and supplies; airlines; and other industries. The businesses which we represent employ more than 1 million people.

Ai Group has been closely involved in the climate policy debate for many years and welcomes the opportunity to make a submission to the Climate Change Authority on its Caps and Targets Review. We look forward to further engagement as the Review draws towards conclusions.

#### **3. Industry impacts of caps and targets in context**

Addressing climate change is as important to the long term interests of industry as to any other segment of society. Solutions need to be economically efficient as well as environmentally effective. Emissions reduction efforts must attract the participation of countries representing a sufficient proportion of global emissions to address the problem and satisfy participants that their efforts are not in vain. The enactment of some forms of effective constraint on greenhouse gas emissions in major producer countries is also vital to prevent distortions to the competitiveness of Australia's trade exposed businesses.

The potential for such competitiveness impacts is the most serious concern that industry has with emissions reduction policy. This concern is particularly acute for Australian businesses at present because of the intense pressures exerted by the strong Australian dollar, weak productivity performance, increased divergence between real unit labour costs faced by Australian businesses and those in other developed economies countries, and rising prices for key inputs such as energy. As a result the primary immediate consideration for industry in considering climate policy generally, and the question of caps and targets in the current Review, is the impact on competitiveness, particularly in the near term. Managing such impacts is largely a matter of domestic policy design in the near term (as is discussed further below), but in the longer term broad international participation is more important.

In light of projected risks from unmitigated climate change, Australia has already made a firm international commitment, with bipartisan domestic backing, to reduce its greenhouse gas emissions. This includes an unconditional commitment to reduce Australia's net contribution to global greenhouse gas emissions (taking into account emissions, sequestration and the use of international emissions rights and offsets) to at least 5% below its 2000 level by 2020. There are also two conditional commitments: to reduce net emissions by up to 15% below 2000 levels if conditions around international action and agreement are met; and to reduce net emissions by 25% if a very strong international agreement is concluded.

Given these commitments, industry has two priorities with respect to a choice of specific emissions goals and caps:

- a) That they do not erode the competitiveness of trade exposed industry; and
- b) That they contribute to a level global playing field by encouraging wider and deeper international participation in emissions reduction.

### **Competitiveness impacts of caps and targets under the current scheme**

The carbon pricing mechanism created by the *Clean Energy Act 2011* makes covered facilities liable for 100% of their annual emissions: they must acquire and acquit permits each year for every tonne of emissions. With this requirement in place, national emissions targets do not directly alter the obligations on business, but simply influence the total number of permits available to all. The competitive impact is determined by two factors:

- a) The price of emissions permits; and
- b) Assistance arrangements for trade exposed businesses.

### *Carbon prices*

When the carbon pricing scheme transitions to trading in 2015, the price of permits will float at whatever level buyers are willing to pay at auction and in the secondary market. In a closed system the price would be determined by Australian supply and demand. Supply would be composed of permits issued by the government within the caps, offsets from the Carbon Farming Initiative, and potentially from permits issued by the government outside the caps at a ceiling price. Demand

would be determined by current and expected activity in Australia’s various covered industry sectors. In such a system the annual emissions caps would be one of the main determinants of the carbon price, as illustrated below.

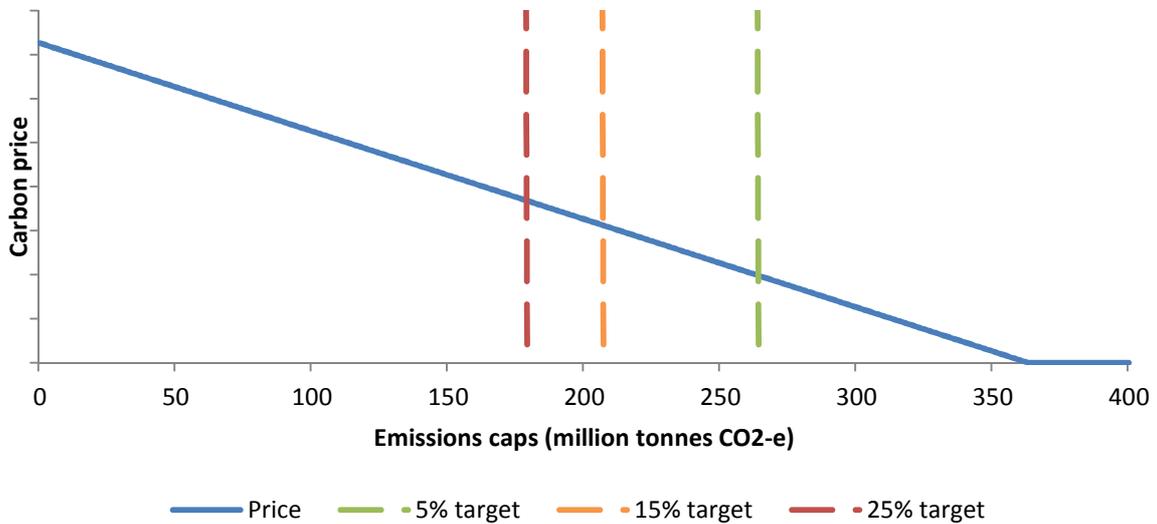


Figure 1 - illustrative relationship of caps and prices in a closed carbon market

Figure 1 above illustrates a stylised relationship between possible emissions caps for 2020 and the carbon prices that might result if the system was closed. It defines demand using recent estimates for baseline emissions from covered sectors in 2020, and includes lines marking plausible caps to achieve potential national targets of 5%, 15% and 25% reductions below 2000 emissions levels.<sup>1</sup> It makes the point that in a closed system without international linkage, any deepening of Australia’s emissions target for 2020 below the existing unconditional 5% commitment could be expected to result in higher carbon prices. Scarce supply would lead liable businesses to bid up the price until it was sufficient to make enough marginal abatement viable to close the gap with demand.

However, under current law, regulations and policy the carbon pricing mechanism will *not* be a closed system and the relationship between targets, caps and prices will be very different. Industry has long argued, and successive governments have recognised, that it is fundamentally in Australia’s interest to link its emissions policies internationally. Linking lowers overall climate policy costs by allowing Australia, a country with advantages in emissions-intensive industries and relatively high abatement costs, to access lower-cost abatement options in other countries, with mutual benefit. Linking reduces competitive distortions by ensuring that Australian carbon prices reflect prices

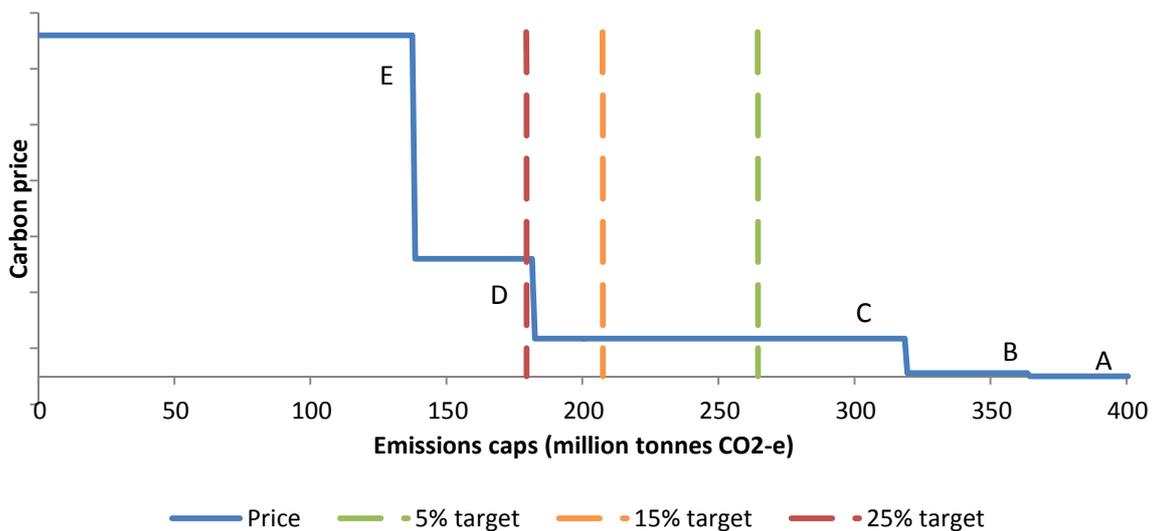
<sup>1</sup> Covered sector 2020 demand derived from Department of Climate Change and Energy Efficiency, *Australia’s Emissions Projections 2012*, including published data for graphs (<http://www.climatechange.gov.au/reducing-carbon/reducing-australias-emissions/australias-emissions-projections>). Targets are translated to caps with the following assumptions: uncovered sector emissions are as projected by DCCEE 2012; the 2000 emissions baseline is 565 mt CO<sub>2</sub>-e; and the cap on covered sectors bears the full burden of achieving the targets, except under the 25% target where current commitments state that five percentage points would be met through government purchase of international units.

overseas; the wider the linkage, the more likely that Australian effort will be in line with actual international abatement ambition.

This logic has been and remains compelling. The current scheme will allow the use of international emissions permits and offsets to meet liabilities from the 2015-16 compliance year onwards. Initially only European Union permits and United Nations offsets will be recognised, though other linkages are possible. Until the 2020-21 compliance year, liable entities can only meet 50% of their liability with international units, of which 12.5 percentage points can be UN offsets. Very large quantities of these units are available on international markets: the EU Emissions Trading System is estimated to be oversupplied by up to 2 billion units to 2020, and the UN Clean Development Mechanism is likely to have issued several billion units in the same timeframe. While both markets may tighten, it is clear they will be more than adequate to meet plausible Australian demand in the foreseeable future.

Under these circumstances the primary determinant of the Australian carbon price under most circumstances would be international carbon prices, particularly the European price. At auctions and in the secondary market, liable businesses will be unwilling to pay more for Australian units than the international alternatives unless the limits on the use of the latter are in danger of binding.

Our analysis, set out in Figure 2 below, suggests that Australian carbon prices would continue to be set by European carbon prices under a wide range of potential caps. As in Figure 1 above, the chart sets out potential caps and targets in light of projected demand. However, Figure 2 takes account of the international units that are legally and economically available, and reasonable estimates of the relative price differences between different forms of abatement, permit and offset.<sup>2</sup> The results set out the broad price levels that different 2020 caps and targets would entail.



**Figure 2 - relationship of caps and prices in 2020 under Clean Energy Act base case**

<sup>2</sup> Exact prices are not included as they would distract from the more robust relativities. Prices involved are a mixture of current forward prices for international units and estimates of Australian marginal abatement costs.

The price levels that are involved are as follows:

- A. No scarcity. If caps are looser than expected demand, prices would only stay above zero to that extent that scarcity was expected under future caps beyond 2020; the ability to bank permits would give them some value.
- B. UN prices. If the gap between the emissions cap and actual demand is small enough to be met through use of UN Certified Emissions Reductions, the UN price will set the Australian price. Until 2020 businesses may meet up to 12.5% of their liabilities with CERs. CER prices are very low due to extremely strong supply and weak demand (particularly from Europe, the largest buyer).<sup>3</sup>
- C. EU prices. European emissions units would set the Australian carbon price if CERs were inadequate to meet demand but caps were not so tight as to hit the 50% limit on use of international limits. EU prices have fallen as Europe is meeting its emissions targets much faster than expected, thanks to a combination of recession and policy.<sup>4</sup>
- D. Medium-cost Australian abatement. If domestic permits were capped at around half of actual demand or less, prices would start to be set by the marginal cost of Australian abatement options. At the moderate cost end these would include some energy efficiency and land sector activities.<sup>5</sup>
- E. High-cost Australian abatement. For extremely tight caps, very expensive abatement investments would be required, particularly in replacing existing electricity generation capacity. As the caps deepened prices could be expected to rise steeply, particularly given technology costs and practical bottlenecks in a 2020 timeframe.

The 50% limit on use of international units does not apply past 2019-20; beyond this point, international prices will very likely set Australian prices no matter how deep caps might go.

Given the size of the European and UN markets, plausible levels of Australian demand are unlikely to move their prices; political decisions about the design and future evolution of both schemes, and their linkage to new sources of demand, will be much more significant to price levels than any change in Australian targets. Such international decisions will be of vital importance to Australian abatement costs and industry impacts, regardless of the level of Australia's emissions caps.

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<sup>3</sup> While the limits on CERs and EU allowances directly apply to individual liable entities, not the economy as a whole, it is very likely that firms would be prepared to maximise the use of their entitlement if Australian unit prices showed signs of rising above international prices.

<sup>4</sup> While the European Parliament recently voted down a measure to tighten supply in its carbon market and raise prices, it remains possible that similar reforms will be enacted over the next several years. Measures currently under discussion are not likely to raise EU prices sufficiently to change the merit order in Figure 2, however.

<sup>5</sup> Some low cost Australian abatement would happen earlier in the merit order (and indeed is built in to the DCCEE 2012 emissions projections used here to forecast demand). There are many different views on the volumes (and exact costs) of medium- and high-cost Australian abatement that might be available by 2020. The more important (and robust) finding in this analysis is the inflection point as prices begin to be set by domestic abatement costs, which are higher than plausible medium term international prices.

### *Assistance arrangements*

After the price, the second factor that determines the competitiveness impact on industry is the arrangement for free allocation of permits to emissions intensive trade exposed (EITE) industries under the Jobs and Competitiveness Program (JCP). This policy is needed as long as comparable emissions constraints do not apply in economies that are the source of import or export competition to liable Australian industries; without it, these industries would be severely disadvantaged, and emissions would shift rather than reduce. The system is far from perfect; Ai Group has long been concerned at the situation of the many trade-exposed businesses that do not qualify for the JCP but nonetheless experience significant business impacts. However, the allocation does significantly reduce competitive burdens for those who qualify, without sapping the incentive to reduce emissions intensity.

It is crucial that the EITE allocation system be maintained in full for as long as it is needed – which may be for a long time, even given improving action in some key competitor countries. China is implementing regional emissions trading schemes and may move to a national version late this decade; South Korea has legislated an ETS to begin in 2015; and South Africa is developing a carbon tax, also for 2015 implementation. All of these policies, and others in Europe, North America and elsewhere, include strong and long-lived safeguards for trade exposed industry – mostly through free allocation, comparable in some respects to the JCP. Thus even if all overseas schemes currently planned were to be implemented, any reduction in safeguards would need to be closely coordinated with all relevant countries and would likely extend over many years.

While the present Review is not directly concerned with the adequacy of EITE assistance arrangements, the choice of caps and targets does have the potential to undermine these arrangements. Allocations to individual EITE businesses depend on individual business production, historic industry-average emissions intensities and slowly declining allocation factors. However, the total number of permits that may be allocated under JCP each year must fit within the emissions cap. Thus targets and caps that cut too deeply too soon could effectively scale back assistance before competitive circumstances warrant it. That would be an existential threat to some of Australia's largest industries.

The seriousness of this risk depends not just on the choice of caps and targets but on future production in trade exposed industries that qualify for JCP. Projections of such matters are highly uncertain. Actual demand for JCP allocation in the 2012-13 compliance year is running well behind what was anticipated in 2011, with serious competitive pressures and weak demand reducing many firms' output and the permanent retirement of some production capacity in emissions intensive industries. By contrast the production of liquefied natural gas (LNG) is set to increase dramatically over the next several years, from 24.3 million tonnes per annum (mtpa) in 2012-13 to 85.5 mtpa by 2019-20, based on facilities with firm financial approvals. An increase in absolute allocations to LNG will offset reduced demand elsewhere.

Figure 3 below sets out potential permit requirements for the EITE program against the same cap and target range as in previous figures. Three highly simplified scenarios are used to capture some of the spread of possibilities:

- **JCP high** – non-LNG EITE industry production grows at 3% annually. LNG production grows based on currently approved projects.<sup>6</sup> This represents the potential for a return to growth in key sectors if there is a major shift in competitive conditions.
- **JCP medium** – non-LNG EITE industry production remains steady at 2012-13 levels. LNG production grows based on currently approved projects.
- **JCP low** – non-LNG EITE industry production declines by 3% annually. LNG production grows based on currently approved projects. This represents the potential for further permanent losses in capacity in key emissions intensive sectors.

The implication is that the choice of caps and targets for a 2020 timeframe is unlikely to impinge on the adequacy of the JCP in the medium term. Given that the *Clean Energy Act* includes a target to reduce emissions to 80% below 2000 levels by 2050, post-2020 targets will be extremely important to the adequacy of JCP. It will be important that any discussion of such longer term caps and targets take these impacts into account, along with information from the Productivity Commission’s reviews of JCP and broader reviews of the Act.

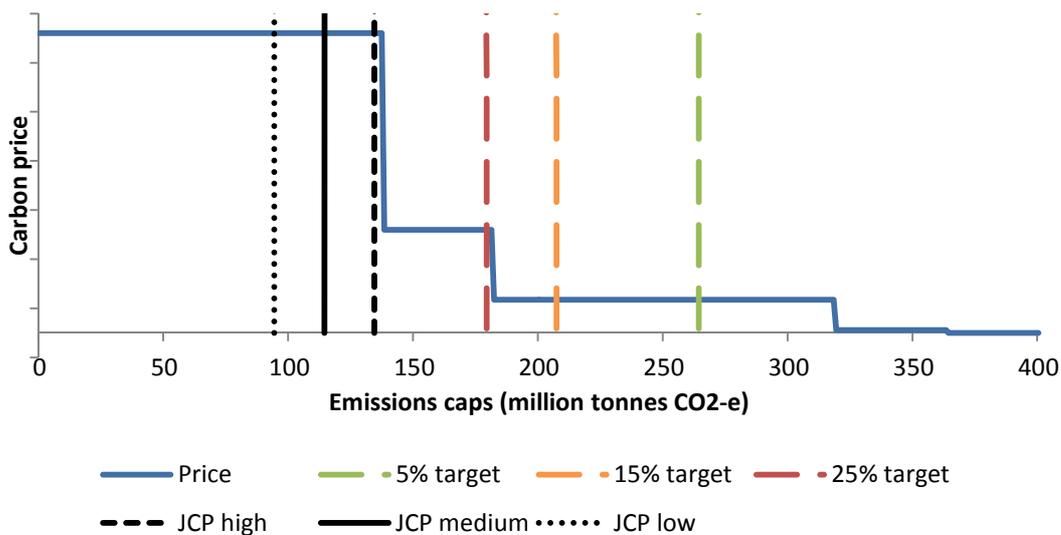


Figure 3 - comparison of scenarios for Jobs and Competitiveness Program permit allocation requirements against potential caps and targets in 2020

<sup>6</sup> While another 35.7 mtpa of LNG capacity has been proposed, it is not incorporated into this scenario. The likelihood of new entrants in the Asian LNG market, shifts in relative costs and the cautious approach of proponents to further Australian LNG investment make the timing and capacity of any further facilities highly uncertain.

### *Summary*

The imposition of an obligation to acquire and acquit emissions permits for all emissions puts a significant burden on liable businesses. Under current legislation, regulations and policy, and given a plausible range of projections for domestic and international market conditions, the choice of caps and targets has a limited impact on that burden. Any reduction in practical access to international abatement would fundamentally change this situation.

Given the severe pressures facing trade exposed industry, Ai Group strongly urges the Commission to avoid the choice of any cap or target that would result in an increase in Australian carbon prices above international levels.

We also urge the Commission to ensure that its recommendations leave adequate room for the continuation of the Jobs and Competitiveness Program for as long as it may be needed, taking into account uncertainty about future production levels in trade exposed industries.

### **Encouraging a level global playing field**

Solving the climate problem while minimising competitive distortions requires broader, deeper international effort. As a middle power, Australia cannot compel other countries to take on deeper emissions targets or tighter obligations. We may be able to play a positive role in encouraging greater action through negotiations, soft power, and market demand for low-cost international abatement. Success in such efforts could be more significant to the global climate than the direct impacts of domestic Australian emissions policies. However, our capacity for influence should be viewed realistically and employed carefully.

International emissions reduction efforts have several mutually interacting origins:

- multilateral negotiations, particularly under the United Nations Framework Convention on Climate Change (UNFCCC);
- plurilateral and bilateral negotiations and relationships outside the UNFCCC, such as the Major Economies Forum (MEF) or Japanese bilateral offset crediting agreements; and
- unilateral domestic policies, such as Australia's carbon tax or China's regional emissions trading schemes.

Australia is active in the UNFCCC, participates in the MEF and has considerable bilateral engagement on climate policy, particularly with other economies that operate or are developing domestic market mechanisms. The targets and conditional targets that Australia chooses can have some modest influence through these channels, but only if they are seen to be deliverable at acceptable economic cost. Climate negotiations are an iterative process, not a once-and-for-all deal; aggressive pledges that cannot or will not be met undermine the development of trust on which the process depends.

It may also be important for tactical reasons to maintain a distinction between the targets and ambitions that Australia applies at a domestic level and the targets we are willing to commit to internationally. The operation of Australia's carbon pricing mechanism requires caps and targets to be selected in 2014. However, it would be quite possible to withhold a clarification of our

international commitment – or to commit to reductions less ambitious than those actually likely to be achieved domestically – in order to retain leverage for deeper commitments by others.

#### 4. Selected issues for feedback

The issues paper sought feedback on several matters not directly covered by the discussion above on industry’s core competitiveness concerns. Some of these issues are addressed below.

Issue	Response
Should the Review make recommendations on emissions goals beyond 2020?	Some discussion of post-2020 targets is unavoidable given the requirements of the Act, and desirable since these questions will increasingly arise as negotiations on a post-2020 international agreement continue. The Review should not make firm recommendations on post-2020 targets at this stage, but should outline the issues and illustrate the potential economic consequences of different target offers.
Should Australia’s goals align with our Kyoto Protocol commitments, or take broader matters into account?	While it is worthwhile for the Review to consider bunker fuels and other matters that may not fall within Australia’s Kyoto Protocol obligations, national targets should not be framed to include such matters until and unless international agreements on shipping and aviation are reached.
How should Australia’s targets be framed to reduce uncertainty and assist in managing risk?	The Authority can best contribute to a reduction in uncertainty by clearly distinguishing its central recommendations – for five years of caps and a 2020 target – from additional matters which do not go directly to immediate government decisions, and where relevant by framing the latter as guides to the thinking which will influence future cap and target recommendations.
To what extent have the Government’s existing 2020 target conditions been met?	<p>It is clear that the specific conditions around the 25% target have not been met; a comprehensive global agreement is yet to be concluded, and collective commitments fall well short of what is required to stabilise greenhouse gas concentrations at 450 parts per million of carbon dioxide equivalent.</p> <p>With respect to the conditions around a 15% target, while there have been significant emissions reduction commitments from Annex I countries and some relatively high-income developing countries, it remains unclear whether these amount in aggregate to reductions in the range of 15-25% below 1990 levels. While Russia has recently adopted a 25% target (at the high end of its previous conditional range), Japan is widely expected to soften its current 25% target in response to its post-Fukushima energy challenges. The impact of South Korea’s target for a 30% reduction against business as usual projections for 2020 will depend on a forthcoming Korean decision on the BAU forecast. There is also a question about whether what has been achieved to date at Copenhagen, Cancun, Durban and</p>

Issue	Response
	<p>Doha amounts to ‘an international agreement’, particularly since negotiations for a truly comprehensive agreement will continue through 2015.</p>
<p>To which countries should Australia compare itself in determining emissions reduction goals, and what metrics should be used?</p>	<p>One of Ai Group’s principles for climate policy is that Australia should ensure that its emissions reduction effort is in line with the action and ambition of other major economies. This includes taking into account the extent to which major emerging economies are constraining their emissions and whether efforts by advanced economies are comparable to our own.</p> <p>‘Effort’ is an important and useful concept, but not a simple one. Mere comparison of targets is inadequate, since the same percentage reduction against a given baseline can represent a much greater or lesser challenge depending on events since the baseline and national economic characteristics. For example, Russia’s commitment to constrain emissions to 25% below 1990 levels translates to an increase of around 13% on 2005 levels, thanks to post-Soviet industrial restructuring. Australia’s unconditional 5% commitment is very significant given the emissions growth otherwise expected.</p> <p>A 2010 paper by McKibbin, Morris and Wilcoxon (<a href="http://www.brookings.edu/research/papers/2010/05/27-copenhagen-mckibbin-morris-wilcoxen">http://www.brookings.edu/research/papers/2010/05/27-copenhagen-mckibbin-morris-wilcoxen</a>) illustrates how much the choice of comparator matters when assessing the relative burdens represented by different national target offers. And the picture grows even more complex when comparisons move from more abstract modelling of targets, to modelling of actual policies institute to meet targets.</p> <p>There will remain considerable room for argument between nations about how best to define comparable effort. Every nation will put forward a metric that shines a flattering light on their own efforts, and most of these viewpoints will be valid to some extent. Australia needs to be realistic, and cautious about seemingly neutral metrics that do not match our national circumstances.</p> <p>However, from the point of view of industry, ‘effort’ is more about prices than targets. Appropriately designed price mechanisms with international linkage allow prices to flex in response to the actual level of international ambition. Lower ambition means less demand for permits and offsets in linked schemes, causing prices to fall. Such flexibility greatly reduces the risk that a poorly chosen target will translate into excessive competitive burdens.</p>

Issue	Response
How should Australia's carryover of emissions units from the first Kyoto Commitment Period be used?	The use of Australia's surplus of Assigned Amount Units will not materially affect domestic carbon prices or industry impacts, whether they are used to offset existing commitments or support further commitments.
Should tighter caps be used to hedge against uncertainty in emissions estimates for uncovered sectors?	There is significant uncertainty in both covered and uncovered sectors, as discussed above with respect to EITE industries. Caps should be based on the most probable outcome anticipated, but a clear statement of risks is needed. Risks from uncovered sector emissions should be borne by government, which can offset any impact on Australia's international commitments with purchase of international units. Economically efficient emissions constraints should be applied to uncovered sectors for equity reasons, though this is unlikely to affect carbon prices for covered sectors, particularly beyond 2020.
How should emissions from heavy road vehicles be treated?	The Review should proceed on the basis of current law, and not assume passage of future laws.
What are the opportunities and risks from linkage with international carbon markets over the long term?	<p>Consistent with the foregoing, Ai Group strongly supports international linkage of carbon markets, on the basis that it lowers the global cost of abatement and widens action. There are three potential risks that some have raised with international linkage.</p> <p>One is that linkage leads to reliance on offshore abatement to the exclusion of transformation in the domestic economy. This fear is misplaced on at least two counts. Firstly, the point of emissions policy is not and should not be to encourage any particular investment in any particular location, but to ensure that global emissions are reduced as efficiently as possible. Secondly, it is unlikely that linkage would lead over the long term to a total reliance on international units; if international ambition is significant, linked carbon prices will eventually justify a greater emphasis on domestic investment. If such ambition does not materialise it is questionable whether greater domestic abatement would serve any purpose.</p> <p>A second worry is that linkage leaves Australian carbon prices vulnerable to overseas market forces and political decisions. This is true to some extent – but applies to almost every aspect of the Australian economy. The benefits of openness tend to greatly outweigh the costs.</p> <p>Thirdly there may be risks from linkage with particular markets that are poorly governed or understood. This risk is real, and even well governed systems with different architectures may have serious problems linking. The decision to link should be taken carefully and with as full a mutual understanding as possible, including on respective mitigation ambitions.</p>

