AUSTRALIAN INDUSTRY
GROUP

24 February 2014

20 Queens Road
Melbourne VIC 3004
PO Box 7622
Melbourne VIC 8004
Australia

ABN 76 369 958 788

Tele: +613 9867 0111
Fax: +613 9867 0199
www.aigroup.com.au

Emissions Reduction Fund Submissions
Department of the Environment
GPO Box 787
CANBERRA ACT 2601

Dear Sir

SUBMISSION ON THE EMISSIONS REDUCTION FUND GREEN PAPER

The Australian Industry Group welcomes the opportunity to provide input on the Government's proposed Direct Action policy. A strong commitment to full consultation is evident in the formation of the Expert Reference Group, the various technical working groups, and the extension until 1 July 2015 of the proposed commencement of the safeguard mechanism.

Climate change is inextricably an economic issue, and policy responses to it have potentially very significant economic impacts. Through consultation with our members and long engagement with the debate, Ai Group has developed firm principles to guide our response to policy. The full set of principles and detailed sub-principles is reproduced at **Attachment B**, but in brief they are:

1. Australia should ensure that its emissions reduction effort is in line with the action and ambition of other major economies;
2. The competitiveness of Australia's trade exposed industries cannot be eroded;
3. Australia should be able to meet its international emissions reduction commitments at least cost;
4. Climate policy must respect existing investments to avoid acute short-medium term disruptions while supporting efficient long-term investment in the energy and other sectors;
5. A central feature of policy should be supporting research and development of new approaches to emissions reduction and refinement of existing approaches; and
6. Compliance and regulatory burdens should be kept to a minimum.

These principles are central to our consideration of all climate policy proposals, including the Emissions Reduction Fund and any other elements of the Government's Direct Action plan. In the detailed comments attached we provide several constructive proposals for improving

the ability of the policy to attract participation, manage financial and abatement risks and achieve the Government's emissions reduction goals. These include:

- Providing confidence that companies offering abatement at auction will be able to recover their full project costs within the five year contracting limit proposed by the Government;
- Lowering the cost and risk of participation in the auctions by either removing the 'make-good' requirement for proponents whose projects do not meet expectations, or allowing the use of international emissions credits for this purpose;
- Securing the availability of ERF funding through a Special Account and a legislated appropriation;
- Removing or substantially reworking the safeguard element of the scheme to increase cost-effectiveness; and
- Allocating around 5% of total ERF funding to 2020 for the establishment of a reserve of international emissions credits to guarantee achievement of the bipartisan emissions reduction target.

We look forward to further opportunities to provide input on the elements of the Government's policy.

For any questions about this submission, the appropriate contact is Tennant Reed (03 9867 0145, tennant.reed@aigroup.asn.au).

Yours sincerely,

Innes Willox
Chief Executive

ATTACHMENT A

DETAILED RESPONSE TO THE EMISSIONS REDUCTION FUND GREEN PAPER

1. Introduction

The Emissions Reduction Fund (ERF) is currently designed around meeting the unconditional bipartisan commitment to reduce greenhouse gas emissions to 5% below 2000 levels by 2020. This commitment should continue to be clearly framed as relating to a reduction in Australia's net contribution to global emissions, rather than simply relating to Australia's domestic emissions and removals. A net contribution approach helps ensure emissions reductions are least cost and environmentally effective, by taking account of Australia's ability to buy abatement and emissions rights offshore, and by considering 'carbon leakage' effects where emissions are moved from Australia to other countries. It has been clear for many years that Australia faces relatively higher marginal abatement costs than many other countries, and that we have a strong national interest in access to low cost abatement opportunities overseas. This interest should be reflected in the framing of goals and the implementation of policy to meet them.

The unconditional -5% target has been accompanied by a range of additional deeper targets with conditions relating to international emissions reduction action. The current status of these conditional commitments should be clarified as soon as possible, preferably in the ERF White Paper. This is particularly important as the conditions were first drawn up in 2009, and there has been considerable change in the international context since then. Consultation and guidance is also needed on the framework the Government will use in developing any post-2020 commitments it may offer.

The Green Paper proposes that achievement of emissions reductions at least cost be the primary and overriding goal of the ERF. Ai Group strongly supports this framing – noting that it should extend to least cost opportunities wherever they are found. Inclusion of additional goals and consideration of co-benefits would be likely to introduce confusion to the policy and make it difficult to assess abatement options in an objective and consistent manner.

Finally, we note the importance of innovation to long term emissions reduction. Research, development, demonstration and commercialisation of new and improved low emissions technologies should be a central element of policy. The ERF as currently described will be expected to fund abatement efforts using commercially available, proven technologies, and is unlikely to provide either 'technology push' or 'technology pull'. It is appropriate for the ERF to focus on meeting near term emissions goals at least cost. However the ERF policy should be complemented by other innovation policies to bring down longer term abatement costs, including Carbon Capture and Storage Flagships, ARENA and so on.

2. Crediting emissions reductions

The Green Paper proposes avoiding the use of financial additionality tests for abatement proposals in order to simplify the scheme and reduce costs. Avoiding a mandatory requirement to demonstrate financial additionality is sensible as a general approach, but there are significant abatement options that are financially additional but might be excluded by the simpler approaches suggested in the Green Paper. In particular, there are a number of existing emissions reduction projects undertaken in industry in response to previous climate policies, including the carbon pricing mechanism. These projects include gas-fired cogeneration systems and scrubber or catalyst systems to reduce emissions of industrial gases. The capital costs of these projects have already been incurred, but they also have ongoing costs to operate – particularly cogeneration, since gas is an increasingly expensive fuel. In the absence of a financial incentive these systems are very likely to be shut down, resulting in an increase in emissions.

The financial incentive needed to maintain existing projects will be much lower than that needed to justify new projects of the same kind. The continued operation of these facilities should, therefore, be able to be a source of abatement credits which can be sold in the reverse auctions. However, this reasoning depends ultimately on a financial additionality approach. Either the ERF crediting mechanism should be open to the option to consider financial additionality where proposed by participants, or another approach should be devised that allows these projects to be credited (such as defining particular classes of investment, such as cogeneration and scrubbing systems, as outside usual practice).

Ai Group supports the approach of allowing methodologies to be developed on either an activity or a facility basis. Methodologies based on corporate group accounting could be complex and their exclusion is appropriate so long as the activity and facility approaches are flexible enough to encompass measures such as the rollout of more efficient equipment across a large number of sites or a transportation network.

The Green Paper suggests considerable reliance on aggregators in order to tap low-cost opportunities across the economy that involve individual parties who are unlikely to be willing or able to participate directly in crediting and auctioning mechanisms. Aggregators will indeed be essential for this purpose. However while aggregation may help reduce overall transaction costs, there would still be considerable costs and risks involved in identifying, agreeing, implementing and monitoring a large number of individual abatement projects and activities. Attractive conditions will be required if aggregators are to be encouraged. Creating those conditions involves much more than making the crediting mechanism easily navigable. The central requirement is in fact that the auction mechanism provides adequate returns and manageable risks. Demand for credits is likely to come almost exclusively from the auction process. The safeguard mechanism will not be a significant source of demand if the Government achieves its expressed intention not to penalise business as usual activity. International demand for Australian credits is unlikely to be substantial given the existing strong supply of much lower-priced Certified Emissions Reductions. Therefore whether aggregators arise to pursue large but dispersed abatement options depends on getting other settings, including the auctions, right.

3. Purchasing emissions reductions

As currently understood the ability of the ERF to deliver the abatement sought at least cost rests entirely on the reverse auction process. It is therefore crucial that this system balance risks and rewards to ensure adequate participation while maintaining high standards. There are several respects in which the tentative structure outlined in the Green Paper can be improved.

The Green Paper proposes limiting the term of ERF credit offtake contracts to five years; a longer-lived project would need to rebid and recontract if it was to sell further credits to the ERF beyond this initial period. The five year limit has been raised by a wide variety of Ai Group members as a serious disincentive to participation in the ERF. Most abatement projects will involve substantial upfront investment producing abatement over a long period, often after a significant delay. At the moderate carbon prices the Government has previously suggested, these projects will not be able to recover much of their cost within the five year window. Thus potential bidders would need either to increase their bid price to ensure total project costs are recovered within five years or run the risk that their investment becomes uneconomic if they do not secure a further contract in later years, whether because they are uncompetitive at auction or because the policy framework has changed. Many would opt to stay out of the auctions altogether.

It is not clear why a five year limit on contracting is needed. Longer contracts are unlikely to lock the Government into relatively expensive abatement, since the lowest-hanging fruit will be picked first. Over time, the abatement options that are available are likely to grow more expensive if deeper targets are undertaken in the longer term, and locking in some abatement at a lower price would be to the Government's advantage. Long term contracts would only involve payment on delivery, as proposed in the Green Paper, and the standard terms could easily allow termination if proponents failed to deliver. Longer term contracts are common in other contexts where the Government seeks to encourage efficient long-term investment, such as infrastructure; 30 year contracts for road operation are not uncommon. Ai Group strongly recommends that the ERF Regulator have authority to strike contracts of terms longer than five years if required.

If the five year limit is maintained, potential bidders would be reassured and more likely to participate if the Government signals clearly that it is willing to pay a high enough price to cover project costs and a reasonable return within a five year window, and that the auction framework will allow bids along these lines to be competitive. Failure to do so would risk over-investment in projects with a higher real cost of abatement. This is because longer-term projects may have significant up-front costs; if these are to be recovered within five years they will carry a high cost per tonne of abatement if the metric used focusses only on the contract period. However, an assessment of cost per tonne over the life of the project would give a much lower, and more accurate, indication of the attractiveness of the project. Meanwhile, a shorter term project recovering its full costs within five years may appear to have a relatively lower cost if assessed against the contract period rather than the crediting period. For these reasons, if the five year limit is retained we recommend that bids are judged on the basis of their cost per tonne of abatement against the project crediting period, rather than the contract period. However this would raise budgetary issues for the ERF, since some of the ERF's funding to 2020 would effectively be used to purchase abatement

realised after 2020. Monitoring, reporting and verification of abatement during and after the contract period would also be an important issue.

The Green Paper also proposes a 'make-good' requirement for successful bidders whose projects do not deliver the full abatement contracted for. The desire to minimise public risk is understandable; if contracted projects do not deliver, government might face higher costs than anticipated to secure alternative abatement, or be unable to source sufficient abatement in time to meet its own commitments. However, make-good simply transfers these risks to bidders; this might lead repeat bidders to increase bid prices to cover the risk of a make-good penalty, but is more likely to simply discourage participation in the auctions. A proponent would face the risk not just of losing their own investment if a project did not deliver, but also of losing as much again or more by having to purchase alternative abatement credits. Such a proponent may be in a weaker position to obtain a good price for these credits than the government monopsony.

Government has better options to manage these risks. Pre-qualification assessment of projects prior to their entry to the auctions is already part of the Green Paper proposal and should be strongly emphasised; this would help weed out any proposals that are unlikely to deliver, and while the costs of the assessment would need careful control they would be unlikely to create the ungovernable risk of a make-good. Projects that failed to deliver abatement should simply be met with non-payment and termination of contracts. The Government could take a risk based approach to its abatement purchase program, allowing the Regulator to contract for a larger volume of abatement than needed – within its existing range of tolerable prices – on the assumption that some will ultimately neither be delivered nor paid for. If these assumptions are overly pessimistic and early purchases result in a higher amount of abatement delivered, later purchases can be adjusted downwards while honouring contracts with earlier bidders. Finally, the Government could purchase credible international emissions units to cover any delivery shortfalls at lower cost and with great certainty. Taken together, these measures would eliminate the Government's financial and abatement risks without discouraging bidders.

If the Government determines to retain a make-good for contracted abatement, there is an alternative approach to reducing risks. If contractors are allowed to make good using international carbon units, their financial risks are radically reduced; UN Certified Emissions Reductions (CERs) are available in high volumes at very low prices, and would be easily obtainable on the secondary market with a low transaction cost and greater certainty about pricing than a thinner market in local credits would provide. If standard credit offtake contracts specify that proponents who instead submit CERs will be paid a CER-pegged price, set on the basis of an agreed market benchmark during a defined period prior to surrender, there would be almost no difference in financial risk for proponents between make-good and non-payment approaches. A contractual commitment to pay only a CER-pegged price if CERs were submitted rather than domestic credits would prevent proponents from arbitraging between domestic contracted prices and CER prices. However, making proponents the middlemen for CER purchases would not make the government any better off compared to direct purchases, and overall transaction costs are probably minimised if government manages the purchase of CERs itself. Thus access to international units for make-good is a second best to the preferred approach outlined above.

As noted, prequalification processes are appropriate to ensure that projects that succeed at auction are more likely to deliver the abatement expected. Any prequalification requirements should relate exclusively to the ability of the project and proponent to succeed; unrelated matters such as impacts on employment or prices or on other environmental indicators should not be introduced as hurdles. It will be important to allow adequate time for proponents to satisfy appropriate requirements around access to finance and acquisition of relevant regulatory approvals. Criteria for prequalification should be transparent and well publicised as early as possible.

The Green Paper proposes to set a confidential benchmark price for auctions, and to exclude bids above this benchmark. It is unclear whether the confidentiality of the benchmark can be maintained for long, even if the benchmark adjusts over time. In any case, bidders who are excluded at auction should be given reasons and an opportunity to rework and resubmit their bids.

As originally proposed the ERF was understood to seek to pay each source of abatement a price reflecting its own costs plus a return – in other words to price discriminate between abatement options. This price discrimination would help ensure that the budgetary cost of abatement purchases was minimised. However in practice bids may wind up clustering around a marginal price, once sufficient information about supply and demand builds up over several auction cycles. Since the Green Paper the Department has indicated in consultations the possibility of a single clearing price approach, which would pay a common price to all bidders. While this approach could maintain some pressure for lower bids prices, it would seem likely to lead to higher average prices than originally anticipated. That is good for encouraging participation, but the implications for the ERF budget should be considered in the White Paper.

The Green Paper also proposes minimum and maximum bid sizes in the auction process. It is unclear why a minimum bid size is needed; very small bidders are unlikely to participate directly anyway, given the transaction costs involved. A minimum bid size that was set too high would add additional costs for projects that could have navigated the process in their own right. Similarly, the scheme should be able to function without a hard and fast maximum bid size; even very large bids could be accommodated if the regulator had adequate authority over the purchasing program and its budget as a whole, within a 2020 emissions budget mandate.

This raises the question of the fit of the ERF within the Budget framework. Standard Budget dynamics are a poor fit for the ERF. Hard spending caps or emissions purchasing requirements in individual years make little sense, as would the reclamation of underspent funds. The ERF has one big abatement task to 2020, and potentially beyond. With respect to Australia's second set of commitments under the Kyoto Protocol, there is a total assigned amount of emissions allocated to Australia, averaging 99.5% of 1990 emissions over the 2013-20 period. The ERF administrator needs considerable flexibility to approach this task strategically over the decade, minimising overall costs by having greater freedom to use its overall funding to purchase abatement as and when it makes most sense. Institutional arrangements to guarantee effective disbursement of the committed funding are also important, and are discussed further below.

4. Safeguarding emissions reductions

Ai Group welcomes the proposed delay to 1 July 2015 of the 'safeguard' mechanism, which will allow further consultation. However the Government should be open to taking further time for consultation if necessary. The safeguard mechanism raises some difficult issues that will take time to resolve.

One fundamental question is the purpose of the safeguard. The Green Paper states that it will "provide incentives not to exceed historical emissions baselines"; that the ERF as a whole will "allow businesses to continue ordinary operations without penalty"; and that the mechanism "will safeguard the value of funds expended under the Emissions Reduction Fund and provide businesses with a stable and predictable policy landscape in which to make new investments."

As we have argued before, if the intention is to constrain emissions to business-as-usual levels, by definition no policy is required to achieve this; business as usual emissions are those that result when there is no policy to constrain them. Where businesses increase emissions they do so in response to the economic conditions they experience or anticipate. And since future economic projections are always inaccurate to some degree, reifying the projections of any one point in time as an expectation of business as usual carries risks that penalties will be incurred because of forecast error rather than behaviour or investment decisions.

The intention may be to prevent emissions reductions purchased through the auction process from directly leading to emissions increases elsewhere in the economy – for instance, through the resale and use of inefficient equipment replaced through the ERF. However, the elements of the safeguard mechanism as currently proposed do not look well suited to this purpose. Emissions coverage, while significant, is not wide enough to perform a safeguard role; coverage of the land sector is minimal, and the overwhelming majority of business facilities are below the reporting thresholds (though the majority of emissions are covered). The suggested historic high point absolute emissions baselines would be well above current emissions for many businesses, creating slack in the sum of baselines (though constant absolute baselines would arbitrarily penalise some businesses for ordinary activity, as discussed below). The combination of limited coverage and slack means that the safeguard mechanism might not contribute significantly to confidence in the emissions reductions purchased at auction. Monitoring, reporting and verification of the projects themselves, plus scrutiny of wider existing data sources, are more plausible measures.

The Government's expressed intention is not to penalise business as usual activity, and therefore not to use the safeguard mechanism as a direct driver of emissions reduction. With this in mind, we reiterate that the White Paper should articulate a clear rationale for this mechanism and pathways for its cost effective implementation. Doing so will assist development of an agreed outcome through the additional year of industry consultation to which the Government has committed. We also recommend that any legislative provisions needed to underpin the safeguard mechanism be developed in parallel with the consultation process, rather than including broader enabling provisions in an earlier ERF legislative package.

Setting aside these fundamental questions about the mechanism, we have several comments on the specifics discussed in the Green Paper. With respect to coverage, whether overall coverage is adequate or excessive depends on purpose. Moving to a 100 kilotonne facility threshold, rather than adopting the NGER threshold of 25 kilotonnes, would slightly reduce administrative costs and reduce industry exposure to potential compliance costs. It would not increase burdens on covered facilities so long as the safeguard mechanism is not intended to drive emissions reductions. A higher threshold therefore may be modestly beneficial, though only with this proviso. Inclusion of both Scope 1 and 2 emissions within a safeguard baseline is sensible to avoid distorting fuel switching decisions. However it will also be important to handle the issue of double-counting between generators' Scope 1 emissions and their customers' Scope 2 emissions.

The proposal in the Green Paper appears to be that baselines would be absolute, constant, facility level and set at the highest point in existing NGER data for each facility. This approach would be extremely simple and have negligible administrative costs. However, the resulting baselines would need to be used with caution. Ai Group has consulted with its members on how such baselines might track their expected future emission profiles. Many are still running the numbers, or face serious uncertainties. However, two points have become clear.

One is that many businesses are likely to remain below historic emissions levels for some time, whether because of efficiency improvements or changes to their markets and operations. In these cases baselines would meet the Government's goal of not penalising business as usual behaviour, though the baselines would also be too loose to allow any meaningful connection with the crediting mechanism or serve a safeguard role.

Secondly, it is clear from our discussions that a range of situations exist in which the proposed baselines would penalise ordinary business activity. These include:

- Highly efficient businesses that ordinarily increase production by small amounts each year to remain competitive, without a single major upgrade event that would trigger a new 'significant expansion' benchmark;
- Businesses that face a commercial imperative to fuel switch from gas to coal or grid electricity, driven by the increase in gas prices;
- Mine sites, which tend to grow more emissions intensive over time as higher-grade or more accessible deposits are extracted;
- Businesses with major capital equipment that grows less efficient over time and is periodically replaced, such as some kinds of furnace;
- Businesses that have operated multiple sites at well below their maximum productive capacity, which are considering consolidating production to one site.

Each of these examples shows businesses operating as they would be expected to in response to market conditions. In each case, a constant absolute historic high point facility baseline would impose a penalty. In some cases that penalty would be incurred in the first year of a safeguard mechanism's operation, while in others there would be some delay. It

would be possible to avoid this by taking additional factors into account in devising baselines, or in judging whether a baseline had been breached: emissions intensity, forward looking emissions projections, changes in economic conditions, facility specific technical issues. However, each of these factors would require additional data gathering and verification, and will introduce cost and uncertainty. Some member companies in the resources sector have advised us that forward-looking emissions projections for their businesses are extremely difficult, relying on geological factors that may not be known with sufficient clarity for years. The costs of developing a more robust baseline approach need to be balanced against the overall benefits that the safeguard mechanism is intended to deliver.

In order to meet the goal of providing a framework for investment, the White Paper should clarify whether emissions baselines are intended to remain constant or evolve over time, whether through a predetermined trajectory or periodic review. Permanent baselines would become less relevant over time, but updates could be complex. An intensity option would work for some businesses, though depending on the measure intensity can also be quite variable and additional compliance costs would be involved. A rolling mean or median may be simplest, though only a partial solution under either absolute or intensity metrics. Industry needs clarity on this issue.

With respect to compliance, we acknowledge the Government's intention not to raise any revenue from the safeguard mechanism. Imposing a make-good requirement on facilities breaching baselines, which would require them to acquire a corresponding quantity of emissions credits, would meet this objective. However it is important to note that such a requirement would still impose a cost on the business concerned, with potential impacts either on its trade competitiveness or, if it is not trade exposed, on the prices its customers may pay. These impacts will need to be carefully considered before any compliance obligation is imposed.

If there is to be a make-good requirement, competitive impacts and national abatement costs could be minimised by allowing compliance with credible internationally sourced emissions credits or rights. While these credits are very likely to remain highly affordable for the foreseeable future, the Government could also set a ceiling on compliance costs by establishing an option to contribute to an emissions reduction technology fund at a fixed rate per tonne of carbon dioxide equivalent, similar to the arrangement in the Canadian province of Alberta.

Given the Government's intention not to penalise ordinary business activity, it would be expected that the final version of any safeguard element will be unlikely to provide a significant source of demand for emissions credits, whether domestic or international. This should be taken into account when considering the scope for secondary markets to supplement the official ERF auction process.

Finally, with respect to the proposal to establish best practice benchmarks for new facilities or major expansions, we note that this raises particularly difficult issues and will need extensive consultation in the year ahead. Defining best practice has been a long and expensive process - even when outcome-based rather than focussed on technology inputs - in the emerging carbon regulation system of the United States and the carbon pricing system

of the European Union. In light of the intention not to penalise business as usual, and the recognition in the Green Paper that new entrants and major expansions are likely to be at best practice anyway, the best practice benchmarks may add little value to the overall policy. If the benchmarks are developed it will be important to provide clarity on the boundary with historic baselines – at what point does an expansion become large enough to trigger a new benchmark? The regulations dealing with treatment of Emissions Intensive Trade Exposed activities under the *Clean Energy Act* and the *Renewable Energy (Electricity) Act* define a significant expansion as involving an increase in the maximum productive capacity of a facility of more than 20%. This may provide a model, but would need close consultation.

5. Carbon Farming Initiative

The Carbon Farming Initiative is a useful basis for significant parts of the proposed crediting system. Expanding the CFI to encompass new sectors and abatement methodologies is positive, though considerable outreach will be needed before these sectors are familiar with the processes and opportunities involved. Ai Group supports moves to streamline the CFI while maintaining its overall rigour. Monitoring performance through sampling has the potential to significantly reduce abatement costs, though the sampling program needs adequate frequency and the resources to operate effectively. Probabilistic approaches to deeming abatement, with appropriate discounting of the credits issued on the basis of risk, will reduce the costs and difficulty of involvement in the system.

6. Administration

As argued above it is important to give the ERF administrator considerable flexibility to shape the auction program, abatement trajectory and spread of funds in order to maximise the cost effectiveness of the abatement effort over the whole period to 2020. The existing Clean Energy Regulator is a good fit for the role, though additional resources and skill sets will be required.

While the National Greenhouse and Energy Reporting Act is the logical vehicle for any provisions to enable the safeguard mechanism, as previously stated the legislation should not be amended in this way until the mechanism is much better developed, understood and agreed.

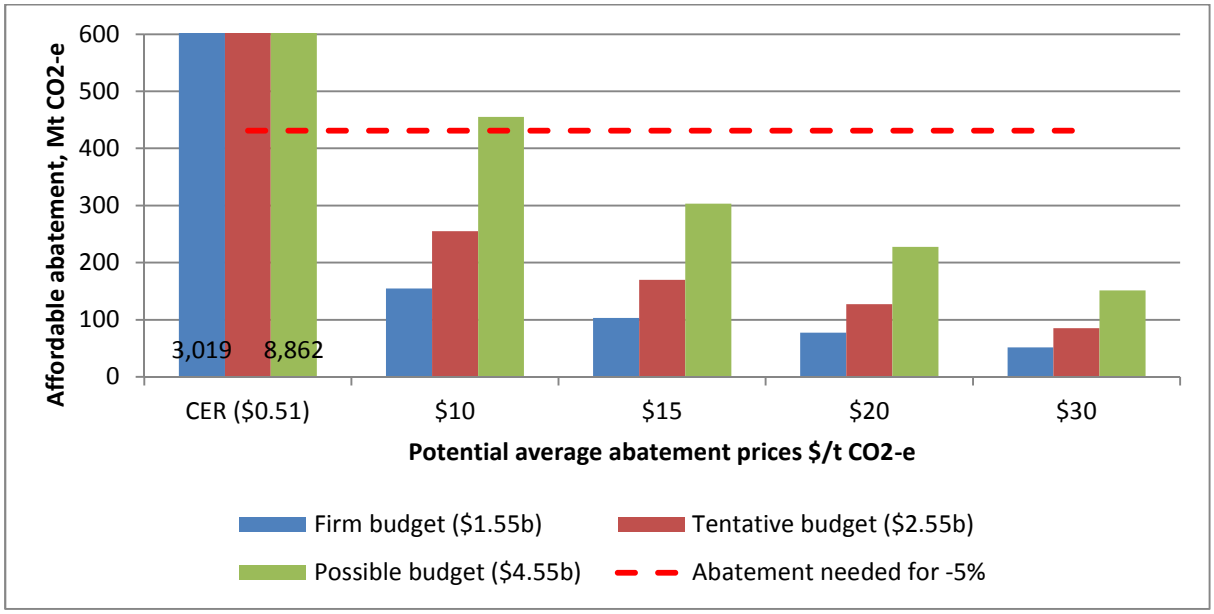
Further to the measures discussed under the auctioning section there is a very important opportunity to structure the administration of the ERF to encourage participation. It will be very important to establish the credibility of the funding committed to the ERF, since this funding is the sole driver of abatement in the policy as currently understood. Announced budget funding commitments have a long history under all governments of being regularly modified, cut and reallocated in light of subsequent fiscal pressures. While businesses that reach funding agreements or sign contracts with government can reasonably rely on these to be fulfilled, developing major projects that offer large scale abatement, in line with the expectations in the Green Paper, may take years to reach a stage where they are ready to contract, particularly if the stakes are raised by a make-good requirement. Certainty about the future availability of announced but uncommitted funds is crucial to inducing business to prepare such bids. And it is also essential to the enthusiasm and expansion of businesses who might consider a business model of repeat transactions as an aggregator or service

provider to projects. These functions are crucial to maximise bid volumes and lower transaction costs.

The Government could provide greater certainty over the availability of ERF funds through three steps.

The first is to confirm the size of the ERF budget commitment to 2020. Currently there is a relatively firm budget commitment to $1.55 billion in funding to 2016-17; an indication of a further $1 billion in 2017-18; and a looser statement that subsequent funding will average around $1 billion per annum. That would imply a total budget to 2019-20 of around $4.55 billion. The size of the budget is central to the ERF's ability to achieve its goals. The chart below sets out the indicative amounts of abatement that could be secured by a perfectly functioning ERF under different total budgets and with varying assumed average carbon prices. Unless the scheme incorporates low cost international abatement options, it is apparent that the maximum budget will be needed.

Figure 1 - ERF abatement potential by budget and price



The second step would be to establish a formal Special Account for the ERF and specify in legislation the conditions under which credited funds could be withdrawn, including some variation on the recommendation of the independent scheme administrator. This approach, comparable to that for the Future Fund and the Building Australia Fund, helps provide greater confidence in the handling of funds and the rigour of their disbursement.

The third step would be to embed appropriations for the ERF into its enabling legislation, consistent with the quantum and timing of the Government's announced commitments. This will ensure the ERF is not dependent on annual Budget appropriations, with all the variability they entail. A similar approach has been taken with the Australian Renewable Energy Agency.

These three steps would not provide absolute confidence; legislated appropriations can be changed if the Parliament so votes. But they would be very positive, providing bidders with much greater certainty that funding would be available if affordably priced supply comes forward. These steps would not increase the Commonwealth's total costs over the period to 2020. They would involve a departure from usual Budget management practices, but no more so than other Commonwealth initiatives with similar needs for long-term credible commitments.

Finally, the Government should elaborate further details of its review of the future of the ERF and emissions policy. The current proposal is for a late 2015 review. However, the ERF may not have a significant track record by that point, particularly since the safeguard element will have been in operation for less than six months at most. A review could therefore easily be held earlier or later; earlier may be more useful for guiding investment, and potentially to give greater clarity and room for consultation on the framing of any offer Australia may take to the late 2015 Paris negotiations on a new global emissions reduction agreement. Whatever the timing, the review should be independent and widely consultative. Beyond this initial policy-setting review, regular independent assessment and review of the performance of the ERF and the regulator would be sensible.

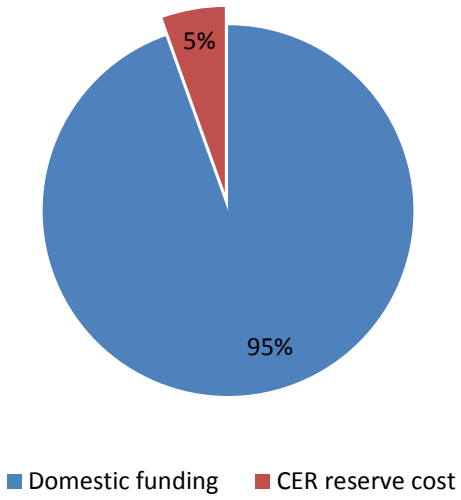
7. Additional measures

Given the central role of abatement purchasing in the Government's emissions reduction plans; the potential for risks and cost to dissuade some participation in the auction process; and the substantial difference between likely Australian abatement costs and international emissions credit prices, Ai Group strongly suggests that, in the interest of achieving the Government's targets at least cost, the ERF policy find a way to incorporate access to international units. Use of such units for any make-good requirements, as discussed above, would greatly reduce the damage such requirements might do to participation and competitiveness. However, we also suggest the ERF incorporate a strategic reserve of international units, established at the outset.

UN Certified Emissions Reductions are available in very large volumes, several times larger than Australia's total projected abatement requirement to achieve the -5% target. While some categories of unit have faced questions about their additionality and are not widely accepted for compliance, the vast majority are recognised as environmentally sound. CERs are the product of a system not unlike the crediting mechanism in the ERF, but this system has access to a much larger pool of potential projects with significantly lower costs than are to be found in Australia. Furthermore, prices are deeply depressed by an imbalance between strong supply and demand that has been slashed by recession in Europe, the major demand centre. As a result CER prices have fallen to around AUD$0.51 per tonne of carbon dioxide equivalent.

Taking advantage of this opportunity would allow the Government to establish a CER reserve large enough to guarantee achievement of the 2020 target at a cost of around $200 to $300 million. This insurance policy would cost as little as 5% of a total ERF budget of up to $4.55 billion. Such a reserve would not obviate the need for domestic abatement purchasing. However it would lower the stakes, and perhaps create room for a greater focus on innovation or longer term projects within the funding mix.

Figure 2 - Cost of full CER reserve as share of ERF funds to 2020



Finally, the Green Paper foreshadows the potential for new policies to complement the ERF, including regulated standards for passenger vehicle fuel consumption or energy efficiency schemes. Such measures should only be adopted after close examination and extensive consultation, including cost benefit analysis and a regulation impact statement. It is also important that existing and new State and Federal policies that impact emissions reduction are mutually coherent and coordinated as much as possible.

Ai Group Climate Policy Principles

The Australian Industry Group's key climate policy principles are, at their highest level, centred on the preservation of competitiveness; least cost abatement; energy security; fostering research, development and deployment of low-carbon technologies; and minimisation of compliance burdens. These top-level principles have more detailed implications, like the need for climate policy to avoid simply adding to general-purpose revenue.

Ai Group's National Executive has endorsed the following framework as a basis for assessing proposed climate policies. Bolded text is a principle, underlined text is an elaborated sub-principle, and subsequent text is explanatory.

1. 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.

Australian climate policy should be flexible so that it can be adjusted in response to the actual level of emissions reduction action and ambition in major advanced and emerging economies.

For example, weaker action or ambition in these economies should lead to lighter burdens on Australian business. Conversely, policy should be able to strengthen if warranted.

Australia should develop and promote a credible basis for assessing and comparing the efforts of different countries. Regular reviews are needed.

2. The competitiveness of Australia's trade-exposed industries cannot be eroded.

a. Global action is fundamental to preserving Australian competitiveness and should be actively promoted in international forums. The starting point for maintaining competitiveness is global action. Even strong measures aimed at trade exposed industries cannot maintain Australian competitiveness over the long term without global action; eventually, the burdens of maintaining such policies while cutting national emissions would become insupportable. Governments should use every opportunity, including though the G20 to push for global action.

b. Neither Emissions Intensive Trade Exposed industries nor the broader trade exposed sector should be unfairly disadvantaged against overseas competitors while global action remains patchy. All major economies have pledged targets or actions, but while mostly significant, these are not yet sufficient to prevent serious competitive impacts from an Australian carbon constraint. Strong measures are needed to maintain the position of Australia's most vulnerable industries against unconstrained competitors. While different specific measures may be appropriate for the most emissions intensive industries and for the broader trade exposed sector, measures for the latter should be no less effective.

c. Policy should build Australia's long-term competitiveness, including in energy. Even under a globally consistent carbon constraint, long-term Australian competitiveness will be damaged unless we adapt effectively to a low carbon global economy. An important part of this will be ensuring a continuation of Australia's advantage in relatively cheap energy. Policy should support an efficient pathway to energy sources that will be globally competitive in the long term under a carbon constraint, whether that turns out to mean gas or coal with carbon capture, renewables, or even nuclear energy. Investments in infrastructure for the transmission and distribution of energy must modernise these systems to capture the benefits of decentralised generation, greater flexibility in fuel sources, and effective management of demand and supply.

3. Australia should be able to meet its international emissions reduction commitments at least cost.

a. Policy should cover the broadest practical base of emissions. The more emissions are covered by policy, the more widely abatement action and costs can be spread. While practical factors may narrow the base, this intensifies the abatement burden for covered sectors.

b. Policy should drive all credible and internationally recognised forms of abatement. Many forms of abatement are available: reductions using existing or future technology to improve carbon efficiency, sequester carbon in the landscape or change energy generation; behaviour change; and imported abatement. Minimising costs requires that all these options be open and that they compete for resources on a common basis. The economic cost to Australia of emissions reduction is only justified if it contributes to an international mitigation effort that reduces climate change. If we rely on abatement that is not recognised as meeting Australia's commitments, we must either undertake additional abatement at further expense, or risk undermining the international framework that justifies the cost of abatement.

c. Market mechanisms will generally be most efficient in locating and driving least cost abatement. While regulation or direct government funding can have a role in some circumstances, bureaucratic or political decision making are usually poor substitutes for the judgments of market actors responding to price in light of their own circumstances.

d. Complementary measures should be adopted only where they can achieve abatement at lower cost than market mechanisms, or enable markets to work more efficiently. Markets will not work in every instance, and they can be made to work better – for instance through measures to address information gaps or agency problems. Such interventions should be chosen with care to ensure they actually minimise costs.

e. Any interim measures preceding a long-term climate policy should be consistent with longer-term policy directions, have acceptable start-up and phase-out costs and must achieve least cost abatement, including on a net present value basis, to ease the transition to longer term policy. There is a role for interim measures in the lead-up to a long-term mechanism, but these can easily turn out to be high-cost or more trouble than they are worth to bring in and phase out.

f. Distortions and perverse incentives should be minimised, especially those that discourage early movers. While climate policy is intended to correct a market failure, it can easily introduce failures and distortions of its own if not carefully designed. Abatement incentives can be positive or negative, but they must be allowed to operate, rather than being blunted, if abatement is to be least cost. Policy must also avoid creating incentives to defer or drop abatement investments that would most efficiently be made now.

g. Climate policy should not increase the state share of GDP, and any resulting revenue should either be returned to individuals and business, or used where necessary and cost-effective to address legitimate needs directly related to climate policy. Some plausible forms of climate policy would raise revenue for the Government, but simply increasing state revenue and general spending is likely to detract unnecessarily from growth, dynamism and overall welfare. Climate policy will entail important spending needs, such as assistance to households and severely affected industries to address equity concerns, assistance to trade-exposed industries to address competitiveness impacts, funding for research and development, and other matters directly related to climate policy. Any such spending should be efficiently designed to minimise the overall costs of mitigation, and any surplus should be returned to the economy – including through reductions in other taxes.

4. Climate policy must respect existing investments to avoid acute short-medium term disruptions while supporting efficient long-term investment in the energy and other sectors

a. A clear, predictable and well designed long-term policy is vital for business to make efficient long-term investment. Perfect certainty is unachievable, and the quality of policy is vital, but there is no doubt that substantial uncertainty over the timing and direction of climate policy is a serious barrier to investment in energy and other major industries across the economy.

b. Policy should provide a clear and supportive environment for new energy investment. The problems of policy uncertainty are especially serious in the energy sector. Forward looking investors need reasonable confidence about the regulatory environment that will apply over the life of their investment. That environment must be a supportive one, however, if investment is actually to result.

c. Any carbon pricing policy should balance price certainty and flexibility. Price flexibility allows savings if abatement costs are lower than projected, and a better match with changing economic conditions. However, too much volatility and price risk – on both the upside and downside – will harm investment.

d. Policy should smooth shocks in the energy sector, ensure that any generation exit is orderly and satisfy existing investors' legitimate expectations. Sudden shocks from climate policy may cause intense difficulties for some generators. This would mean risks to near-term energy security, impose serious loss on existing investors, increase the cost of transition and dissuade future investment. Policy should smooth shocks and satisfy investors' legitimate expectations. The impacts of structural adjustments in the energy sector on affected companies and communities must also be addressed.

5. A central feature of policy should be supporting research and development of new approaches to emissions reduction and refinement of existing approaches.

a. A market for low-carbon goods and services is necessary for broad-based innovation. The development of low-carbon products and technologies will be severely constrained unless innovators are confident that a low-carbon product will be more profitable than a high-carbon substitute. The existence of an actual market is a more plausible spur to innovation than the unpredictable availability of year-to-year grants or subsidies.

b. Additional support is needed to reflect spillover benefits from carbon innovation and the high costs of commercialising some new technologies. Even with a market reward, low-carbon R&D produces benefits for society at large that the researcher cannot capture. If R&D is not to face underinvestment, further assistance will be needed, whether through the tax system, grants, prizes or otherwise. Some promising technologies, including renewable energy technologies and carbon capture and storage, require significant support through demonstration and deployment phases if they are to achieve their potential.

6. Compliance costs and regulatory burdens should be kept to a minimum.

a. Policy should achieve maximal coverage with a minimum of parties directly involved or regulated. While all Australians and companies are responsible for greenhouse emissions to some degree, administrative costs and burdens would be insupportable if more than a small fraction of emitters were directly regulated or liable under carbon policy.

b. Policy should rely on existing data and reporting systems wherever possible, with any new processes imposing the minimum additional burden necessary for good governance. While policy needs information to operate, a great deal is already collected and new requirements for additional or slightly different data can easily become very costly. Processes to judge difficult concepts like 'additionality' are especially likely to be expensive, time consuming and inflexible.

c. Policy should drive the elimination and avoidance of unnecessary, duplicative and unduly burdensome climate regulation. A vast array of largely uncoordinated climate policy already exists and the political incentive for more is constant. Much of this would be unnecessary or avoidable under a broad long-term policy.