The Australian Industry Group

SUBMISSION TO THE 2017 CLIMATE POLICY REVIEW

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About Australian Industry 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 members operate small, medium and large businesses across a range of industries. Ai Group is closely affiliated with more than 50 other employer groups in Australia alone and directly manages a number of those organisations.

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The Australian Industry Group welcomes the opportunity to provide input to the Review of Australia's Climate Change Policies. Our membership includes businesses of all sizes across many sectors who are impacted in many different ways both by climate policy and climate change itself. The existing suite of policies has contributed significant emissions reductions, principally from the land sector, at a substantially lower cost than anticipated. However, the current Review is an important chance to ensure that Australia has a policy mix that can meet our needs over the long term. This chance should not be missed.

The need for new policy

Australia has made substantial commitments under the Paris Agreement:

- our current Nationally Determined Contribution (NDC) to reduce emissions to 26-28% below 2005 levels by 2030;
- our commitment to the long-term Paris goals of:
    - constraining the rise in global temperatures to well below 2 degrees centigrade, or 1.5 degrees; and
    - bringing anthropogenic sources and sinks of greenhouse gases into balance in the second half of the century – or global net zero emissions; and
- our participation in a continuing process of remaking and upgrading all nations' NDCs over time until the long-term goals are met.

While the Agreement is in many respects non-binding – particularly the content of the NDCs – the compelling logic of Paris is that an extended cycle of commitment, action, verification and recommitment can build trust and elicit higher ambition. Action by many nations is essential both to deal with climate change and to reduce the potential for a loss of trade competitiveness by nations that act. The Paris Agreement has attracted exceptionally broad participation and represents a dramatic break from past approaches which asked little of the developing countries that account for most recent and potential emissions growth. It is the best agreement we are likely to get, and Australia has a strong economic interest in its success. We should act to meet our commitments and encourage others to do likewise.

However, Australia is not on track to meet our Paris commitments, as the Government's projections illustrate (see below). Emissions projections have consistently erred on the side of anticipating higher emissions growth, and there is every likelihood that developments in international markets, the structure of Australia's economy, and technology will see emissions that are well below current expectations. However, the apparent gap to the 2030 NDC remains large and will take significant policy development to bridge. This is particularly so given the fate of Australia's 2020 targets.

In the leadup to the 2009 Copenhagen climate summit, Australia's major political parties committed to reduce our emissions to at least 5% below 2000 levels by 2020, with deeper targets conditional on strong action by other major economies. When Australia formalised that commitment under the second phase of the Kyoto Protocol, it was translated to the format of a Quantified Emissions Limitation or Reduction Obligation (QELRO): emissions to average at 99.5% of 1990 levels over 2013-20.

This commitment was made under the assumption that emissions would start well above the QELRO and drop over time to well below it. Instead, the Global Financial Crisis and the faster-than-expected decoupling of economic growth from growth in energy demand and emissions meant that emissions started well below the QELRO. And economic and policy changes have meant that emissions are rising

and are on track to finish above the QELRO. Thanks to overestimation of initial emissions, the carryover from undershooting the emissions growth allowed in our first Kyoto target, and the abatement purchased through the Emissions Reduction Fund, Australia will likely meet its QELRO. But with three years to go there is no likelihood that we will meet the underlying commitment to hit -5% below 2000 levels in 2020. This will make our 2030 targets even more challenging.

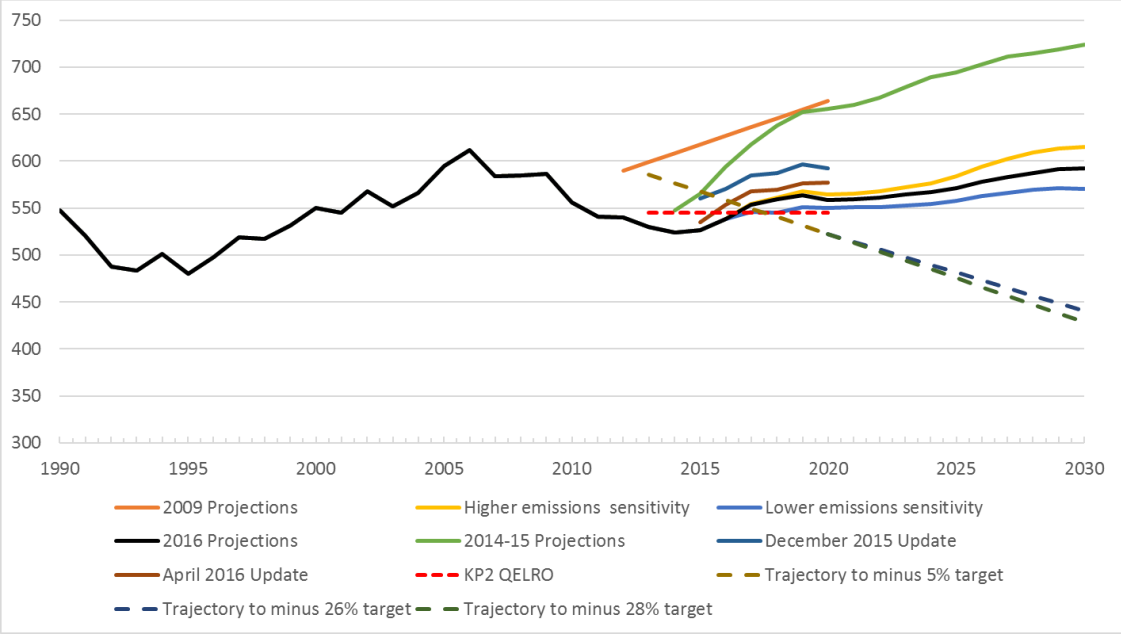

Figure 1 Australian emissions, projections and targets[1]

Current policies are not designed to meet Australia's longer term commitments.

- Bipartisan support for the Renewable Energy Target is an important underpinning for investor confidence in the electricity sector. However, the policy will soon cease guiding new investment, as its large-scale component levels off from 2020 and the whole policy phases out by 2030. The RET is not technology neutral, and Australia's electricity markets have not yet been reformed to ensure high levels of renewables can be integrated.
- The Emissions Reduction Fund has performed well in supporting moderate volumes of low-cost abatement from forestry, land management and waste projects. However, it has already committed most of its allocated funding, and its procedures, contract length and price levels have made it unattractive or irrelevant for industry, energy and even much of agriculture.
- The Safeguard Mechanism has not been designed as a driver of emissions reductions, but as partial insurance against the possibility that emissions reductions in the ERF lead to emissions increases elsewhere in the economy. Its historical baselines will eventually see more and more growing businesses face a penalty, somewhat randomly and arbitrarily.
- The National Energy Productivity Plan has so far involved only modest initiatives and resources.

Taken together, it is apparent that existing Commonwealth policies will not be sufficient for Australia to meet its current Paris commitments; let alone to put us on a least-cost and trade-neutral path to net zero emissions in the longer term. Of equal importance, the absence of effective, durable and

[1] Department of the Environment and Energy, *Australia's emissions projections 2016* (December 2016); Department of Climate Change, *Tracking to Kyoto and 2020* (2009).

bipartisan national policy is a serious problem for long term investment. Policies that are designed to last only a few years, or which are expected to change with every change in government, cannot provide a basis for investment in industrial or power assets that will last for decades.

This lack of investable policy is especially problematic given the serious crises of energy affordability and security that Eastern Australia is experiencing. As Ai Group has outlined in our Energy shock: No gas, no power, no future? report[2] and our submission to the Finkel Review,[3] electricity and gas prices are rising enormously due to the closure of old generation assets and the rise of gas exports. The security of electricity supply is under immediate challenge in South Australia, and in the longer term the rest of the National Electricity Market. Gas availability is in doubt across the Eastern Australian domestic gas market, with demand exceeding current supply and new production limited by regulation and community concern. There are no lasting solutions to these energy challenges without new investment. Without clear, long term and broadly supported climate policy, we will not get the investment that we need. The energy 'trilemma' can also be described as a three-legged stool: without the climate leg, security and affordability fall over too.

The current climate and energy security reviews are the best opportunity the Government will have to reach agreement on policies that will sustain efficient investment and abatement through multiple political cycles. However, stakeholders' confidence in the climate review was shaken when the Government ruled out the possibility of an emissions intensity scheme shortly after releasing very broad terms of reference. While what was ruled out is only one option for only one sector, this episode has stoked concerns that the Government may not be ready to deliver long term policy.

If the Commonwealth is seen as unable to deliver durable policy it is likely that State Governments will fill the vacuum. This is increasingly happening, with various long term targets and energy interventions being considered or implemented by New South Wales, Queensland, South Australia and Victoria. This is a far from ideal situation. The States can play a positive role in areas like land use and transport planning where they have primary responsibility, and their collective cooperation on energy is important. However, a patchwork of uncoordinated State policies on energy or industrial emissions risks chaos and unnecessarily high costs. State policies are equally vulnerable to political cycles and a lack of bipartisan support.

The Commonwealth Government should take control of the situation as soon as possible by affirming its intention to:

- meet the Paris commitments;
- work with stakeholders over 2017-18 to develop effective, efficient and trade-neutral emissions reduction policies for all sectors; and
- seek bipartisan support for these policies.

[2] http://cdn.aigroup.com.au/Reports/2017/Energy_shock_report_Feb2017.pdf.

[3] http://cdn.aigroup.com.au/Submissions/Environment_and_Energy/2017/Submission_Finkel_Review_final.pdf.

Principles

The development of climate policy should be guided by clear principles. Ai Group's climate policy principles, developed with and endorsed by our membership, have guided our policy development over many years.[4] They are reflected in and consistent with the climate policy principles developed and adopted by the Australian Climate Roundtable which represent common ground among a broad cross section the community, including business, environmental, social welfare and union groups.[5] Those state that

> *We recognise the major parties' bipartisan goal of limiting global warming to less than 2°C above preindustrial levels. Our overarching aim is for Australia to play its fair part in international efforts to achieve this while maintaining and increasing its prosperity.*
>
> *Achieving this goal will require deep global emissions reductions, with most countries including Australia eventually reducing net greenhouse gas emissions to zero or below.*

The Principles also state that an ideal climate policy would:

> *be capable of achieving deep reductions in Australia's net emissions in line with our overall goal; provide confidence that targeted emissions reductions actually occur; be based on an assessment of the full range of climate risks; be well designed, stable and internationally linked; operate at least cost to the domestic economy while maximising benefits; and remain efficient as circumstances change and Australia's emissions reduction goals evolve.*

The Roundtable principles include further detail on cost control; trade competitiveness; innovation; equity; stability; adaptation; the use of any revenues; administration and review. Trade competitiveness is a particular focus for Ai Group, since the bulk of our members are exposed to international trade and face potential trade distortions depending on how Australian and overseas policies are designed. With respect to trade, the Roundtable organisations have agreed that:

> *Policy should prevent the unnecessary loss of competitiveness by Australia's trade exposed industries and net increases in global emissions that might otherwise occur due to the uneven international application of climate policies.*

[4] http://pdf.aigroup.asn.au/environment/Ai_Group_Climate_Policy_Principles.pdf.
[5] http://www.australianclimateroundtable.org/wp-content/uploads/2015/06/Climate-roundtable-joint-principles-June-29-2015-final-embargoed.pdf.

Long term goal

Australia's current emissions targets run to 2030. However, as discussed above the Paris commitments also involve long term global goals to avoid dangerous climate change, and these imply that all countries including Australia will have to keep deepening their self-imposed targets over time. Australia has stated that we will consider a long term goal of our own. And major power and industrial assets built now will have operating lives extending well beyond 2030. A long term goal can play a very useful role in coordinating policies and assessing their adequacy, and help investors judge the potential circumstances their future assets may face.

On the other hand, a long term target can only provide so much guidance: circumstances will change and will require a response. An overly rigid long term target will be broken if it remains out of step with developments in international action, the Australian economy or climate science.

There is also the fact that the States and Territories, and some local governments, are increasingly committing themselves to long term goals, usually net zero emissions by 2050. At the subnational level, overly rigid targets can raise serious challenges of cost control, effort sharing and unintended consequences, while looser ones can potentially provide useful coordination.

On balance, the Commonwealth should adopt a non-binding long term vision for emissions reduction, distinct from and in addition to the nearer-term targets to which it commits internationally. The vision should be used to help coordinate and inform domestic policy development and investment, and should be consistent with achieving the widely shared goal of constraining climate change to well below 2°C above preindustrial levels. Shorter term international commitments should be shaped to be constructive but proportionate to the efforts of other major economies, and so are likely to lag the long term goal until there have been several successful rounds of NDC delivery and recommitment under the Paris framework.

A national goal should corral existing subnational ambitions in order to restore the primacy of national policymaking. Thus we suggest that the long term vision should be:

> *Australia is prepared to achieve net zero emissions in 2050, while maintaining and enhancing our prosperity. We will be open to all effective means of abatement, including emissions reduction; sequestration; and trade in valid international emissions units.*

Policy options

Our starting point for emissions reduction policy is the value of consistency and economy-wide reach. Policies that apply carbon constraints across the economy and reflect a consistent underlying price of emissions or abatement are more likely to operate efficiently and achieve least cost abatement. Practical limitations can make sectoral approaches seem more practical and attractive. We acknowledge that the Government is pursuing a set of sectoral policies. In doing so the Government should be careful to avoid three serious risks with the sectoral approach:

- Sectoral policy can result in uneven constraints that result in a more expensive mix of abatement activities than is necessary to achieve the targeted economy-wide reductions.
- Sectoral policy can distribute the costs of achieving abatement unevenly and inequitably, particularly where sectors differ in their ability to pass on costs.
- Sectoral policy can set sectors against each other and concentrate effort on burden-shifting rather than emissions reduction.

One means of limiting these risks is to connect sectoral policies to a common backstop or safety valve, such as access to Australian Carbon Credit Units or valid international carbon units. As discussed further below, these approaches need care but can be valuable.

That said, the Government already has positive measures under development for vehicle fuel efficiency, broader energy efficiency and synthetic greenhouse gas reduction. These are achievable and should be implemented, as long as industry and other stakeholders remain closely consulted. However, these will only deliver a portion of the necessary reductions.

Transport

In transport most effort is currently focussed on light road vehicles. The proposed approach of fleet efficiency standards is widely used overseas and has merit. Standards should be developed and implemented on as rapid a timetable as is workable for vehicle suppliers (and, if necessary, fuel refiners) to comply with. However, two points are worth emphasising:

- The value and impact of standards depends on the effectiveness of monitoring and enforcement. This is not just about deliberate evasion of standards. We are aware of research underway by the Australian Automobile Association which indicates that there is a substantial and growing gap between the performance of vehicles under laboratory conditions and vehicles driven in the real world. Australian vehicle standards need to be judged on real-world costs and benefits.
- Australian discussion of vehicle emissions reduction has largely centred on fuel efficiency and techniques like lightweighting. Much less attention has been paid to electric vehicles (EVs), despite the growing commercial, consumer and government interest in them overseas. EVs are certainly a negligible factor in Australia at present, but projections that they will remain entirely marginal are almost certainly complacent. EVs have the potential both to radically reduce transport emissions and to provide a range of valuable flexibility services to that support the transition of the electricity system. This transformational potential makes it important to ensure that EVs have a full opportunity to compete under a broader vehicle efficiency regime. Standards, transport regulation, physical infrastructure and electricity market design need to allow EV owners to realise their full value.

Energy efficiency

More efficient and productive use of energy has great potential as a source of low cost abatement. Consumption efficiency is also necessary to moderate the overall cost of our energy system, and to help energy users endure the extreme increase underway in the prices of electricity and gas. Nationally coordinated action on energy efficiency has never been more necessary.

Increasing prices will themselves increase the priority that energy users place on improving efficiency. However, there are at least three reasons for further concerted action:

- Energy users cannot currently benefit from all of the value streams created by potential efficiency improvements, including the value of avoided emissions, without supporting policy or market design;
- While the largest and most intensive energy users have sharp incentives and substantial internal resources to focus on energy, most users are less intensive (see below) and face gaps in information, skills and access to finance; and
- Ongoing energy price rises are so large and rapid that businesses and some households may not be able to adapt fast enough to avoid financial distress, even if they are viable in the longer term.

There are also several points of caution.

- The largest and most intensive energy users have do not need mandates or reporting burdens to focus on energy; these are likely to add cost without additional benefit.
- There are several existing efficiency policies, from product standards to white certificate schemes in the ACT, NSW, South Australia and Victoria. New policies should avoid duplication or added complexity.
- Consideration of energy efficiency from a climate perspective tends to value energy savings whenever and wherever they occur. But the value of efficiency to the energy system depends heavily on the time of day and state of demand in the wholesale market segment and distribution network region where the savings take place. It is important to integrate climate and energy policy.

Ai Group supports an ambitious goal to double Australia's energy productivity by 2030, and the development of cost effective policies to achieve this. The broad directions of the National Energy Productivity Plan are positive, though all jurisdictions will need to invest further resources. Supportive policies should be tuned to the particular needs of different kinds of energy user. Existing State white certificate schemes should harmonise and ensure that they are genuinely accessible to both household and business energy users, while jurisdictions without such schemes should consider joining the harmonised model. Energy market reforms being considered through the Finkel Review will be needed to ensure that energy users can be appropriately rewarded for the value created by a range of demand side activities including efficiency, demand response, and distributed generation and storage. These services in turn ease the reduction of electricity sector emissions.

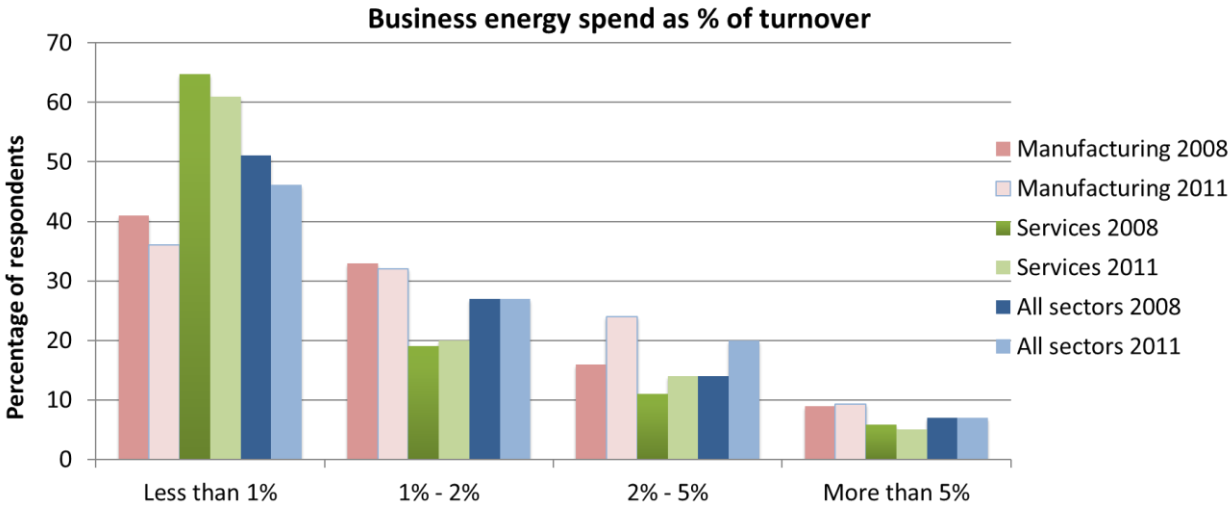

Figure 2 Businesses vary widely in their energy intensity[6]

Synthetic greenhouse gases

The Government's policy to phase down the importation and use of hydrofluorocarbon gases, widely used for refrigeration and other purposes, appears workable and appropriate. The progress of technological alternatives and international negotiations may ultimately allow the schedule to accelerate. It will be important to continue the high standard of industry consultation that has been achieved to date.

Agriculture and land

The land sector has been the most significant source of abatement to date for the Emissions Reduction Fund. There have been concerns that amendments to land clearing legislation in Queensland and New South Wales might lead to substantial increases in emissions; however, we understand that forthcoming emissions data suggests there has been only a modest increase in clearing, with much of this being regrowth removal rather than primary clearing. On balance the land sector seems an important source of future abatement.

Building on existing offsetting arrangements seems to be the most practical and widely supported way forward for the land sector. However, there are continuing concerns from landholders about the complexity and barriers to entry in engaging with the ERF. While the ERF arrangements emerged well from the Audit Office's 2016 report, it will take time for a full picture of the performance of offset projects to emerge. However, the biggest issue for the future of the ERF is demand.

Demand for offsets can come from government; private purchase for compliance; private purchase for other reasons like corporate social responsibility; or international markets.

- It will be several years before Paris Agreement rules for internationally transferred mitigation outcomes are fully elaborated, and while economically and globally beneficial, international sales of Australian offsets will not directly help us meet our own commitments.

[6] Ai Group, *Energy shock: pressure grows for efficiency action* (July 2012). Energy spend measured includes total spending on electricity, gas and liquid fuels, divided by total turnover. Electricity and gas prices have increased considerably since the underlying survey data was gathered in 2008 and 2011, though liquid fuel prices have moderated and energy efficiency has improved.

- Non-compliance private purchases are likely to remain modest.
- Compliance purchases depend on the future of policy for the energy and industrial sectors (see below). It will likely be several years, if ever, before these are significant sources of offset demand.
- Government purchasing remains critical to continued land sector activity. The ERF's rapidly dwindling funds should be supplemented by a further appropriation, perhaps around $200 million per year, to underpin a continued base of offset activity on which other sources of demand can build.

Trade in international units

Ai Group has long held that Australia should make use of valid international emissions units and offsets to control our abatement costs. A tonne of carbon dioxide has the same impact wherever it is emitted – or avoided. Just as for any other valuable commodity, differing national advantages and opportunities mean that trade and an international division of labour can leave all parties better off.

There are three potential concerns about international units: quality, availability, and the need for domestic transition.

- The quality of any emissions units used by Australia is non-negotiable. We should expect that any offset units represent genuine reductions, that compliance units are part of a meaningful and fair national cap, and that any unit avoids double counting. With respect to existing Certified Emissions Reduction units issued under the UN Clean Development Mechanism, there is substantial evidence that most issued units are genuine, while there are genuine concerns about particular classes of unit – especially industrial gas destruction. We should be confident to make use of other valid CERs for our commitments to 2020. The Paris rules around post-2020 units are yet to be elaborated, but must include strong rules for quality and against double counting.
- Availability and price are critical if international units are to help control Australia's mitigation costs. CERs remain enormously available and cheap, largely because of the collapse of expected demand from compliance schemes in Europe and elsewhere. However, it is not yet clear how much abatement from the underlying CDM projects may be credited beyond the second Kyoto commitment period. And more broadly, there is as yet very little basis to estimate the supply, demand and price of international units post-2020. We should be open to using units and work internationally to ensure they are available, but policy should not assume that plentiful and low cost units will be permanently available. If nations continue to increase their abatement ambition over time as the Paris Agreement envisages, unit demand will grow and supply will dwindle.
- Some point to the importance of domestic activity, concerned that reliance on international units may make an untransformed Australian economy vulnerable if and when units are scarcer and more expensive. It is true that in a long term perspective it is unlikely that net zero global emissions will be achieved without deep reductions and economic change in every country, including Australia. And troubles in international markets, or flaws in the design of overseas policies, can be imported through the use of units. The importance of sectors like electricity to the overall transition may warrant care about when and how international units are used. However, trade in international units should be an important tool for controlling costs and a pressure valve for shocks and miscalculations in the domestic economy.

On balance, Ai Group urges the Government to open up to the use of international units by setting aside

a modest proportion of the Emissions Reduction Fund for pre- and post-2020 purchases; pursuing strong Paris rules and mechanisms; negotiating bilateral and plurilateral access arrangements under the Paris rules; and allowing access to international units under the Safeguard Mechanism and any future industrial sector policies.

Electricity

The electricity system urgently needs clear, efficient and durable climate policy in order to underpin new investment. A variety of technology neutral price or market mechanisms could be workable, including emissions intensity schemes, carbon pricing or clean energy targets. All of these have performed well in modelling exercises, with carbon pricing best on total economic cost and retail energy prices least affected by intensity schemes and clean energy targets. Any of these would need careful consultative design, broad political support and a focus on minimising consumer costs to work. However, we note that substantial increases in energy prices are happening anyway, and that inactivity is not a low-cost option.

Old high-emitting generators will close eventually, and closure would accelerate under most climate policies. However, there has been considerable disquiet among energy users and the community over the sudden and chaotic nature of recent closures. There is increasing agreement that future closures would be easier for all stakeholders to plan around if minimum notice periods or maximum asset lives were enacted. Given the rapidly declining costs of renewable energy it is likely that under any technology neutral policy renewables will eventually account for a large share of generation. However, as we have argued to the Finkel Review, the challenges of integrating variable renewables are real and will not be resolved by climate policy. The range of energy market reforms under consideration in the Finkel Review will be essential to ensure the system can digest the change it is already undergoing.

A new policy could commence from 2020, when the current Renewable Energy Target levels off. The existing RET plays an important role in current investment and should be neither further reduced nor continued past its current 2030 phaseout.

Industry

For the industrial sector, building on the current Safeguard Mechanism to drive emissions reductions has at least two challenges. Firstly, the variance between similar facilities' historically derived baselines is high, making flat reductions inequitable; intensity-based baselines would be complex but fairer.

Secondly, there is no element within the mechanism to address trade competitiveness if it starts to bind emissions. Trade competitiveness remains a critical issue for industry despite the Paris Agreement and the many implementing policies among major economies. This is primarily because other countries' emissions policies are nearly always careful to shield their own trade exposed businesses from substantial net costs. For instance, emissions trading schemes in Europe, South Korea and elsewhere typically provide a very high proportion of free allocation for trade exposed activities. These schemes remain meaningful, but do not reduce the urgency of trade concerns.

Access to international units is important for controlling Australia's abatement costs, but does not resolve competitiveness issues: as noted, we do not yet have a clear basis for estimating the price and availability of future units; and in any case, international units can reduce compliance costs, but not eliminate them. Other competitiveness measures should be considered, from baseline top-ups to border adjustments.

Developing an improved Safeguard will take time and close consultation. There is time pressure: eventually an increasing number of businesses will be impacted – somewhat randomly and arbitrarily –

by the current mechanism, as they grow beyond historic production levels. Near term effort to reduce inconsistencies and move growing facilities to intensity-calculated baselines would provide time for longer term measures to be developed. The Safeguard should not be used as a significant source of offset demand unless and until trade competitiveness is addressed.

The Review is a critical chance for the Government to build the effective, efficient, durable and trade-neutral climate policy framework that Australia needs. We appreciate the strong and continuing commitment to stakeholder consultation that the Department has shown and we look forward to more discussion in the months ahead.