



18 May 2011

The Hon Greg Combet AM MP
Minister for Climate Change and Energy Efficiency
Parliament House
CANBERRA ACT 2600

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Dear Minister

Further to the call for submissions at a recent meeting of the Industry Transitional Assistance Working Group, the Australian Industry Group is pleased to provide input on design issues around a possible carbon price mechanism.

As the attached paper notes, Ai Group will reserve its judgment on the Government's proposals until the full detail of a package is available. In the meantime we will continue to engage with the Government to help ensure that any such proposals are practical and meet industry's critical needs. We will need to discuss the Government's detailed proposals with our members, in particular through our National Executive and Branch Councils, before coming to a definitive position.

Yours sincerely,

A handwritten signature in black ink, appearing to read 'Heather Ridout'.

Heather Ridout
Chief Executive

Overview

The Australian Industry Group has been a constructive participant in the development of policy related to the reduction in greenhouse gas emissions for many years. With strong involvement from our members, we have developed a set of Climate Policy Principles (see Attachment A) that have been endorsed by our National Executive and Branch Councils. These principles serve as a reference point for our participation in policy debate and as a benchmark for our assessment of alternative policy proposals.

We continue to work closely with both the Government and the Opposition as they develop their different approaches to reducing greenhouse gas emissions. This submission is a part of that ongoing engagement on this important issue.

Ai Group's membership is diverse and includes electricity generators; suppliers of raw materials, machinery, equipment and services to coal, gas, petroleum and renewable energy producers; suppliers of "green" goods and services and trade exposed businesses ranging across the full spectrum from the most emissions intensive right through to those with very low levels of emissions.

The chief concerns of our members in relation to climate policy are:

- The threats to trade exposed businesses that would compete in export and the domestic markets with businesses that were not subject to the same additional costs in the absence of comprehensive global action;
- The threats to the continuity of energy supply in the face of the substantial transition that will be required in this industry;
- The impediments to investment especially, though not only, in the energy sector due to uncertainty over climate policy;
- That emissions abatement is achieved at least cost;
- That there should be a strong emphasis on research and development into low-emissions technologies; and
- That the compliance costs of climate policy measures should be kept to a minimum.

Ai Group maintains that under an ideal policy, this variety of concerns could be met by adopting a market-based approach to emissions reduction that financed measures to effectively shield trade exposed businesses; ensure the continuity of electricity supply and deliver appropriate compensation to low and middle income households. These measures could be designed in a way that maintained incentives to reduce emissions.

Further, existing high-cost abatement measures could be phased out and effective gateways could be put in place to prevent new high-cost abatement measures being introduced. Research and development into low-emissions technologies could be supported with public investment and encouragement for private sector expenditure.

The Carbon Pollution Reduction Scheme (CPRS), though it had been substantially improved through negotiation by the end of 2009, fell short of the ideal in a number of respects:

- Many trade-exposed companies remained unsatisfied that their competitiveness was adequately safeguarded;
- The effectiveness of the measures aimed to ensure the continuity of electricity supply was questioned;
- There were concerns that the approach to low-emissions R&D was patchy and required further development; and
- There were insufficient processes to reduce the economic and compliance costs arising from high-cost abatement measures at all levels of government.

The changed conditions that we face today make it even more important that any carbon pricing policy more closely approximates the ideal:

- The unprecedented and sustained strength of the Australian dollar is placing huge pressure on exporters and import-competing businesses, many of whom have a drastically reduced capacity to absorb further cost increases;
- Costs for a range of key inputs are rising, from basic commodities to energy, and skills shortages are once again looming. These are already a serious challenge to the adaptability and competitiveness of Australian industry;
- The comprehensive and binding international emissions reduction agreement hoped for before Copenhagen has not materialised. Business does not anticipate such an ideal agreement for many years. Instead we face a world of partial agreements and continuing difficult negotiations, where the carbon constraints that actually apply in relevant industrial sectors and key competitor countries are patchy and hard to assess.
- The bipartisan approach that applied to emissions trading from 2007 to 2009 no longer exists. While both sides agree on the need to take action and have the same targets, the investment certainty that any policy can offer may be reduced by political risk.

For business, a policy that provided adequate and credible shielding; that inspired greater confidence in the continuity of energy supply; that provided adequate compensation for low and middle-income households and that addressed the compliance cost and R&D issues would assist in overcoming these concerns.

Business could then concentrate on participating in the transformation of our economy and the pursuit of opportunities in a low-carbon world economy.

If the fundamental architecture lacked adequate and credible shielding, the broad coverage put forward in the CPRS could be recast, including a phasing of coverage that better addressed the concerns of particularly vulnerable trade exposed sectors.

The Government has asked industry and other stakeholders for submissions on the design of a carbon pricing scheme within the high-level architecture announced on 24 February 2011.

Ai Group is fully participating in the range of consultations established by the Government and engaging with all sides of politics on climate policy in order to ensure the views and vital interests of our members are respected. In that spirit we provide this submission, which outlines how a carbon pricing scheme along the broad lines proposed could better approach the ideal, if it were to proceed.

Nothing in this submission should be taken as pre-judging Ai Group's position on a final carbon pricing package. It is the total impact of a package, and the interrelationship of its component parts, that matters to industry, and it is on that basis that we will judge any more detailed proposals. Any individual option suggested in this submission may still be unacceptable if part of the wrong combination of other options. Ai Group's climate policy principles are reflected throughout and will guide our ultimate consideration.

The issues raised in this submission will need extensive and intensive further discussion with industry if the Government intends to proceed with its proposals for a carbon price.

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1. EITE

If carbon pricing is to proceed, measures specifically aimed at competitive impacts on emissions intensive trade exposed businesses are obviously central. Several issues were unresolved or unsatisfactory at the end of 2009, or have become problematic since. With Australian industry already under severe pressure from the high dollar, there is no room whatsoever to reduce or weaken the November 2009 EITE assistance package, and indeed the EITE arrangements can be improved in several respects. In consultations, our members have raised a number of issues regarding EITE. We conveyed these to the Government in a letter sent recently (see **Attachment B**).

Ai Group's climate policy principles emphasise that the competitiveness of Australia's trade exposed industries cannot be eroded, and that EITE industries should not be unfairly disadvantaged against overseas competitors while global action remains patchy.

Specific measures are preferable for addressing trade exposure issues. However, if these are inadequate, other design issues – like starting prices, escalators and coverage – inevitably become avenues for preventing erosion of competitiveness.

Unresolved activity definition issues

Several activities never received a final activity definition in the CPRS process, including cement milling, sugar refining, coke from brown coal, and briquette manufacture. Many issues remained unsettled around the treatment of Liquefied Natural Gas.

A variety of other activities face changed circumstances since 2007-08, including greater trade exposure, and would likely be submitted for consideration: these include rockwool and glasswool insulation and autoclaved aerated concrete.

Several industries also emphasised the importance of including full Scope 3 costs for natural gas in their definitions; Scope 3 is currently included only where gas is sequestered in product.

Option: The Government should undertake to complete assessment of activities already submitted as soon as possible, and commit to consider any further activities submitted. New assessments should be able to be based on trade exposure and financial data from 2008-09 to 2010-11, allowing reflection of important (and very likely sustained) changes in the value of the dollar and the extent of import competition.

Option: Consideration should be given to extending EITE activity definitions to include all activities that take place in manufacturing processes. Currently, some

industries have had their activity definitions truncated on what they consider to be an arbitrary basis.

Option: If carbon pricing proceeds, the full Scope 3 emissions associated with natural gas should be able to be included in activity definitions. On request from an industry, existing activity definitions should be amended as soon as practical to reflect all gas-related Scope 3 emissions.

Option: Some EITE industries are concerned at the potential for significant Scope 3 costs associated with their use of coal. Regular or special reviews of EITE should be asked to consider any evidence of carbon cost passthrough to EITE coal consumers. If such passthrough is found, relevant activity definitions should be amended to incorporate Scope 3 costs from coal.

Initial allocation rates

The CPRS proposed initial allocation rates of 94.5% and 66% for highly and moderately emissions intensive activities. There have been suggestions from some quarters that these rates be reduced to 90% and 60% respectively, as they were before the 'Global Financial Crisis Buffer' negotiated over the course of 2009.

As the Government would recall, that buffer was negotiated without reference to the GFC, but as an improvement to the treatment of EITE industries; the GFC label emerged at the end. In any case, the extraordinary and sustained strength of the Australian dollar is an even more serious challenge than was the near-recession to the ability of industry to absorb additional costs. Should carbon pricing proceed, there is no case for any reduction of EITE allocation rates below the level of November 2009.

Option: Maintain EITE allocation rates at least at their November 2009 levels.

Option: Provide for a smooth transition between the 66% and 94.5% rates for activities between 1000 and 1999 tonnes per million dollars revenue.

Decay rate

Under the CPRS as at November 2009, EITE allocation rates were to decay by 1.3% annually. However, this decay (and the whole EITE program) would have been reviewed in 2015. The review would have considered whether the decay rate should change for any specific industry; if less than 70% of relevant competitors in that industry faced comparable carbon constraints, it would have been prima facie evidence that allocations for that activity should not fall below 90% and 60% for highly and moderately EITE activities respectively.

This review condition was a significant improvement on the previous situation, where decay might continue regardless of actual conditions in the global markets Australian EITE industries operate in. However, it could be further refined.

The CPRS decay rate was inherently approximate and arbitrary. There are three possible justifications for a reduction in allocations over time:

- a) to reflect business-as-usual reductions in emissions intensity – though this is hard to predict for any individual industry, and certainly cannot be reduced to a single number across all EITE industries;
- b) to reflect increases in the effective carbon prices borne by relevant competitors – though these cannot be predicted and are unlikely to be similar in pacing and scale to the CPRS decay rate; and
- c) to maintain the affordability of the EITE program overall – though this has nothing to do with the proper goal of the EITE program, which should be to preserve both EITE industry viability and abatement incentives in a world of highly uneven carbon pricing.

A decay rate is *not* necessary to provide abatement incentives, since the basic design of EITE fully preserves incentives to become more carbon efficient (with the exception of the 100% cap – see below).

Option: If carbon pricing proceeds, any decay should by default stop when allocation rates reach 90% and 60% for the high and moderate EITE categories. Thereafter allocation rates should only be varied on an activity-by-activity basis, consistent with the advice of the Productivity Commission on shadow carbon prices applying to relevant international competitors in each industry. If the data or methodologies available are insufficient at the time of a review to allow high confidence in conclusions about shadow carbon prices for an industry, no adjustment should be made in the allocation rate for that activity until data or methodologies have sufficiently improved.

100% cap on allocations

The November 2009 CPRS arrangements included a provision that EITE allocations could not exceed 100% of actual liabilities at the facilities for which allocation was sought. The draft regulations reflecting this rule were complex, but appeared to provide that:

- a) the rule applied to the facility or series of facilities for which a particular EITE allocation application was made, noting that while a single application could cover several facilities it could cover only one activity;
- b) In calculating ‘actual liabilities’ of the facilities in question, all emissions were to be included, whether associated with the EITE activity or not, and extending to those associated with electricity consumption. The only emissions not counted were to be those counted within any application relating to other EITE activities at the same facilities, and those associated with any electricity exported to the grid or another facility.

Option: The 100% cap conflicts with a core purpose of the EITE program, which is to fully preserve incentives to become more carbon efficient. If carbon pricing proceeds, this cap should be removed.

Option: If the 100% cap is retained, it should be applied by comparing the total calculated allocation under all EITE applications made by the relevant entity with all actual scope 1 and 2 emissions associated with EITE activities conducted by that entity.

Passthrough in newer electricity contracts

The CPRS EITE arrangements dealt with activity baseline Scope 2 emissions via a national electricity allocation factor of 1 permit per MWh per tonne of product. However, the actual emissions intensity of generation used by EITE industries varies across the country. There was also provision for recognition of cost pass-throughs higher than 1 tonne CO₂-e per MWh in long-term contracts between generators and large electricity users. However, this was limited to contracts entered into before 3 June 2007 and not subsequently renegotiated or reviewed.

Option: If carbon pricing proceeds, there should be full recognition of passthroughs greater than 1 in long-term contracts for large users renegotiated or reviewed between 3 June 2007 and 24 February 2011.

Garnaut approach

Ross Garnaut has recommended that the EITE framework be used for the three years of the fixed price period, but that this time be used to develop the necessary data and methodologies to apply his preferred approach to the trade exposure issue. Garnaut's approach would rebate to EITE industries the difference between the price they are able to obtain for their production, and the estimated price they might obtain if all relevant competitors were subject to an equivalent carbon constraint.

Industry has considered this approach and judged that it is too complex to work in practice. Estimating the hypothetical world price of EITE goods would require an assessment not just of the shadow carbon prices obtaining in relevant economies and subsectors – itself a very challenging endeavour – to see whether any price is already built into the market, but also of how the global market for a given EITE product would react if the Australian price applied.

2. Other Measures for Trade Exposed Businesses

Less intensive trade exposed

Many trade exposed businesses fall outside the parameters of the November 2009 EITE program, yet would be significantly impacted by carbon pricing. Ai Group's climate policy principles state that neither EITE industries nor the broader trade exposed sector should be unfairly disadvantaged against overseas competitors while global action remains patchy.

Ai Group has previously written to the Government with suggestions for how the needs of these businesses could be met. That letter is attached to this submission, but in brief there are three measures proposed:

EITE tier 3

If carbon pricing proceeds, a third tier should be added to the EITE structure, providing free permit allocation to trade exposed activities with an emissions intensity between 300 and 999 tonnes of CO₂-e per million dollars revenue (or 900 and 2999 tonnes per million dollars value added). The existing threshold of 1,000 tonnes per million dollars of revenue could be lowered to 300 and the 66% allocation rate applied or an alternative initial allocation rate could be adopted. Activities would be considered for inclusion as soon as possible, and could be eligible for the other assistance below until their inclusion was agreed. This tier would be likely to benefit activities like sugar refining, iron casting, dairy processing, malt production, some chemicals and plastics activities, insulation and some metal fabricating activities.

Climate Change Action Fund

An enhanced version of the similar CPRS proposal, the CCAF would provide a range of information and on-site assistance to businesses or facilities not eligible for EITE assistance, to help them understand their exposure to carbon pricing and how to reduce it. This assistance would also help businesses seek funding from a substantial CCAF capital pool for energy efficiency and emissions reduction projects. Such funding could be provided through streamlined competitive grants, through Low Carbon Australia, or potentially through an automatic entitlement to co-funding of defined categories of industrial equipment in eligible sectors. Governance structures should be put in place to closely involve industry in rolling out information and defining realistic and workable arrangements for capital funding.

Transitional Electricity Cost Assistance Program

An enhanced version of the similar CPRS proposal, TECAP would assist manufacturing and mining businesses (those with annual electricity use above

300 MWh and not eligible for free permit allocation) with the higher electricity costs attributable to carbon pricing. The assistance would cover 50% of the extra cost for three years, giving those businesses time to take energy efficiency measures, potentially with CCAF assistance.

Support for investment in low-emissions capital equipment

In addition to measures targeted to less emissions-intensive trade exposed, support could be given to businesses investing in low emissions capital equipment. This would assist business address the initial liabilities costs associated with carbon pricing and the costs of making new investments. The support could take the form of capital grants or accelerated depreciation for qualifying investments.

3. Electricity sector

The Government is currently consulting with the electricity sector separately and confidentially. Ai Group places great importance on the continuity of energy supply, and our climate policy principles state that policy must respect existing investments to avoid acute short-medium term disruptions while supporting efficient long term investment in the energy sector. We will need feedback from the electricity consultations before making an assessment of any proposals in this space.

However, we note that the nature of coverage in the electricity sector is crucial to the impact of carbon pricing on most other industries. Furthermore, the quantum and distribution of, and any conditionality attached to, assistance to the sector is of great concern to industry: it can prevent disruptions to immediate supply or medium-term security, and it can affect the mix of energy in the market and the prices we pay. We will assess electricity sector proposals with these factors in mind.

We note that in the context of a slower start to carbon pricing that eases the transition of the broader economy, as discussed below, there is potentially a role for measures that are complementary to a carbon price to support the medium-to-long term transformation of the electricity sector by addressing the impact of uncertainty on investment in the sector. Any such measures should be consistent with expected carbon prices and least cost abatement over the medium and longer term beyond a slower start.

4. Cost control

Any climate policy should aim to achieve whatever level of abatement is sought at least cost. Controlling the costs imposed by a move to carbon pricing is a central concern for Ai Group. Several avenues for cost control are addressed below. It should also be stressed that these may become more or less important depending on other scheme design issues, including coverage, phasing and measures for trade exposed industries.

Starting price and escalator

The Government has announced a preference for a fixed price that rises at a pre-announced rate until the transition to trading. The three concerns to balance in choosing a starting price and escalator are: minimising immediate impacts and shocks on the economy as a whole and particularly trade exposed businesses and households; minimising any shock from the transition from fixed to floating prices; and reaching price levels that enable investments consistent with achieving the 2020 goals, including the coal-to-gas shift in the energy sector. Each consideration points to different prices.

EU ETS allowances (EUAs) are currently trading at around AUD\$23.50, while secondary CDM credits (sCERs) are currently trading at around AUD\$18. Future expectations shape both, with EUAs bankable for use in the upcoming Phase III, and CERs facing uncertain future demand given lack of agreement on a second Kyoto Protocol commitment period.

With respect to long-term impacts on emissions and investment decisions, first-year prices matter very much less than future expectations. A low initial price should not present any problems, so long as it has approached parity with international prices by the transition point and there is confidence that international prices would set the Australian price thereafter.

With respect to price levels needed to support key energy investments and the broader transformation of the economy, it should be remembered that the primary purpose of a carbon price is to meet emissions reduction goals at least cost, and that particular investments or technologies are simply potential means to that end. International carbon prices are very likely to be at least sufficient to support a gradual and efficient coal-to-gas shift. The pace and ambition of the energy sector transformation would – rightly – depend on the extent of global ambition, reflected in international carbon prices.

A further consideration is the value of the Australian dollar, currently causing serious problems for trade exposed industries beyond the resources sector. With trading and international linking the cost of importing permits would adjust with the dollar, and the Australian carbon price would adjust in turn. A fixed price path risks becoming out of step with any further sustained movements in the value of the dollar.

Finally, and centrally for Ai Group, is the question of competitiveness for trade exposed industries. If measures for trade exposed firms are adequate, the starting price and path are somewhat less of an issue in themselves, though a lower starting price would greatly ease the transition. If measures are inadequate, however, a lower starting price would be critical to address competitiveness concerns.

Option: If carbon pricing were to proceed, a starting price of \$10 a tonne – as per the CPRS – would help moderate costs and risks in the initial year, and would assist in reducing the disruption to business and households. A moderate increase in the

early years would extend these advantages as business prepared for a steeper increase in price on the transition to the trading regime.

Option: If carbon pricing proceeds, the fixed price should reflect the best available projections for the exchange rate.

Price path under delayed transition to trading

As suggested below, it would be better in terms of investment certainty if there were a fully automatic transition to trading with no provision for deferral. If deferral were possible, it would be better if the criteria were restricted to the depth of international carbon markets (and thus likely to be satisfied). However, if carbon pricing proceeded and for whatever reason a decision were taken to defer the transition to emissions trading with full international linking, arrangements would be needed to determine the fallback carbon price until such time as trading began.

On balance, it would be greatly preferable for those arrangements to be spelled out from the beginning, rather than decided at the same time as a deferral. The former would minimise the investment uncertainty inherent in the existence of an option to defer. The latter could enable a fallback price more responsive to actual Australian and international developments, but at the cost of establishing a process likely to be complex, unpredictable and politically fraught.

If a delay is potentially lengthy, the question also arises whether the fallback price path would be adequate to meet Australia's emissions commitments or to support (or sustain) long-term investment decisions in the energy sector.

Ai Group's climate policy principles state that a clear, predictable and well-designed policy is vital for business to make efficient long-term investment and that any carbon pricing policy should balance certainty and flexibility.

Option: In the event of a decision to defer the transition to trading, the carbon price could be held to a pre-determined path reflecting the best available projections for international prices in the CDM and EU ETS, accounting for inflation and the high value of the dollar.

International unit imports

Unlimited access to approved categories of international emissions units (initially CERs and ERUs, with scope to include other units over time) was the single most important cost control feature of the former CPRS proposal. With near universal expectations that Australian abatement opportunities would be, on average, more expensive than those overseas, international units were expected to allow Australia to meet its emissions targets while limiting domestic permit prices. Once a category of international unit was eligible for use within the CPRS, there were no further quantitative or qualitative restrictions.

The Government's new proposed architecture would not allow use of international units during the fixed price period, and while stating that such units could be used in the flexible price phase, also foreshadows the possibility of quantitative or qualitative limits on such use.

Ai Group's climate policy principles state that in order to achieve least cost abatement, policy should drive all credible and internationally recognised forms of abatement, including use of international units.

If carbon pricing proceeds, the Government should reconsider the use of international units during the fixed price period. The New Zealand scheme, which also involves a fixed price during a transition period, has allowed international permits without disruption. The Government's concerns over revenue during the fixed price period would be ameliorated by ensuring that, during the fixed price period, the Australian carbon price was set no higher than international unit prices.

There is clearly a case for excluding fraudulent or fundamentally unreliable units, though this should be done in ways that minimise transaction costs and consider the bigger picture of expected abatement represented by a class of units rather than requiring each individual unit to be beyond reproach. A similar risk-based approach underlies the proposed Carbon Farming Initiative (in intention at least, since implementation has not yet begun).

Thus while it may be correct to exclude certain categories or sub-classes of unit on the basis that they do not represent credible or additional abatement, there is no case for further arbitrary restrictions on access to international units, whether quantitative or qualitative. Such restrictions would be not just unnecessary but actively destructive if they were sufficient to bar Australia from access to the units it needs to meet targets at least cost. Unlimited importation and use of valid CERs and ERUs should be allowed as soon as the flexible price period commences, and other credible unit categories should be made available as soon as the necessary bilateral and multilateral negotiations can be satisfactorily concluded.

Domestic offsets (Kyoto compliant)

The Carbon Farming Initiative provides scope for the creation of offsets from certain forestry and other activities that would be counted against Australia's commitments under Kyoto Protocol accounting rules. There have been suggestions (including from Ross Garnaut) that such offsets could be used to acquit liabilities even during the fixed price phase of the new proposed scheme, albeit with quantitative restrictions on how much of an entity's liability could be met in this way.

Again, Ai Group's climate policy principles support the use of all credible and internationally recognised forms of abatement necessary to meet emissions reduction commitments at least cost. If Kyoto-compliant domestic Australian offsets can be purchased at prices competitive with fixed or international prices, they should be allowed into any Australian carbon pricing scheme. Domestic offsets potentially

present the same fiscal risks as international ones during a fixed price period, but these are moderated by the much lower volumes likely to be available in the early years of a scheme. Limits on use of domestic Kyoto offsets are thus unnecessary during the fixed price period, and are entirely inappropriate afterwards.

Option: If carbon pricing proceeds, liable parties should be able to use Kyoto compliant domestic offsets to acquit liabilities from scheme commencement.

5. Architecture & Review

Coverage & phasing

The CPRS would have covered all sectors bar agriculture, legacy waste and some land emissions from commencement, and this apparently remains the Government's preference for a new proposal. There are three other options that have been proposed or are relevant:

1. Electricity only, with no liability for direct emissions outside the electricity sector until there was sufficient international action relevant to a particular industry sector (this would still require EITE assistance as business would remain exposed to electricity cost increases);
2. Exclusion of fugitive emissions from coal and gas extraction;
3. Phased coverage similar to that in the EU and Californian emissions trading schemes, with sectors added over time according to a set schedule. The EU ETS started with electricity and limited industry coverage, with aviation entering in 2012 and the remainder of industry in 2013. California will include electricity and industrial emissions from 2012, bringing in natural gas and transportation in 2015.

Ai Group's climate policy principles state that achieving least cost abatement requires policy to cover the broadest practical base of emissions. However phasing could address implementation risk and the current extreme pressures on some industry sectors.

Option: If carbon pricing were to proceed it could equal CPRS coverage from commencement if appropriate arrangements for shielding trade exposed businesses were in place.

Option: If carbon pricing were to proceed it could add sectors under a phased approach. For example, it could start with electricity in 2012-13, fugitives in 2013-14, industrial direct emissions in 2014-15 and transport fuels in 2015-16. The extra time would allow more preparation for non-electricity sectors, better methodologies for fugitives, better data and methodologies for assessing shadow carbon prices overseas, and fulfillment of Government commitments on offsetting initial petrol price impacts without an ongoing reduction in the price signal after 2015.

Treatment of transport fuel

The CPRS would have covered transport fuels, but fuel excise would have been reduced every six months for the first three years of operation by an amount equivalent to the carbon price impact on diesel fuel (thus significantly overcompensating petrol users). At the end of the three years the reductions would be permanent but no further adjustments would be made. This was estimated to cost around \$2-2.5b annually forever. The benefits of the excise reduction would not have flowed through to heavy road freight (which does not pay excise; a one-year-only boost to fuel credits for such transport was planned, however, and three years of extra credits for agricultural, fisheries and forestry fuel users). Around $\frac{3}{4}$ of the benefit would have gone to passenger car users (largely households) and the remainder to light commercial vehicle users.

Ai Group's climate policy principles state that distortions and perverse incentives should be minimised. We and many other stakeholders in the business, community and environment sectors criticised the fuel measures as an extremely expensive and price-signal-muffling way to deliver poorly targeted household assistance. However, petrol prices are a sensitive issue and are of particular concern to regional communities.

Option: Rather than adjusting fuel excise, impacts on fuel prices could be taken into account in determining the level and nature of a household assistance package delivered through changes to payments and the personal tax system. This would be much more targeted, and less expensive, than excise adjustments.

Option: As described above, if carbon pricing proceeds coverage of road transport fuels could be deferred until 2015-16; they could then be fully included with no adjustment to fuel excise. This approach appears to be slightly cheaper than the CPRS approach even over the first three years, possibly because of the overcompensation created by basing excise cuts on diesel impacts. With no ongoing impacts after inclusion, it would be vastly less expensive than the CPRS approach from that point on. However, any consequential adjustments to household assistance would reduce the savings, albeit for a targeted and non-distorting purpose.

Transition to floating price

The Government's preferred architecture would transition from a fixed price to a floating price after 3-5 years, with a decision no later than one year before the transition date on whether to defer the transition and, if so, on whether to make any consequent changes to the fixed price and/or the escalation rate. If there was no deferral, the Government of the day would set the 2020 target (and presumably caps for the first five floating price years) at that time.

Ai Group's climate policy principles state that a climate policy must be clear and predictable for business to make efficient long-term investments. The option to defer

a transition to trading potentially introduces significant uncertainties, and if carbon pricing proceeds it would be greatly preferable that no such deferral option existed. If an option to defer remains, it should be as simple as possible and restricted to relevant considerations around international markets. The question of the price path following a possible deferral is addressed above.

Option: Ultimately the reason an extended fixed price period is under discussion is that the Government and Greens disagree on targets but are closer on prices. If carbon pricing proceeds, an alternative way to mediate this difference without the uncertainty of an option to defer trading would be to have a one-year fixed price period (as per the CPRS, allowing time to put an auction and trading platform in place) and then move immediately and automatically to trading with full international linking. The legislation would not include a target, but specify that its purpose was to help Australia meet its international emissions reduction commitments. At present those commitments are the unconditional 5% target and some conditional deeper targets. The Government of the day (or other relevant decision-maker, see below) would formulate caps based on the current commitments until such time as further or more specific international commitments were made. While five year rolling caps would remain strongly preferable, there could be provision for adjustment of future-year (but not current-year) caps if necessary to reflect any deeper commitment or obligation reflected in an international agreement to which Australia is party.

Option: If carbon pricing proceeds and an option to defer trading exists, it should be based on a single criterion: whether international carbon markets have inadequate trading volumes to meet Australia's need for imported units. Ross Garnaut suggests a 3 year transition period with a deferral decision based on independent assessment of this single criterion. With 546m CDM CER units already issued, and requested and registered projects set to produce volumes of at least 400-500m units annually from 2012 to 2020, it is very likely this criterion would be satisfied. If carbon pricing were to proceed, and if full international linking were guaranteed in the floating price period, this simple criterion would provide a reasonable basis for future planning. It is also very likely that committed Australian demand for units would create its own supply, since the uncertainty affecting the CDM relates not to supply capacity but demand after the first Kyoto commitment period ends.

Since deferral would remain possible, albeit unlikely, clear arrangements for pricing after a deferral would remain vital.

Governance – review bodies, status & future of PC work, independent regulator

Governance under the CPRS proposal involved an independent agency administering the detail of permit issuance (and eventually auctioning) and free allocation, but all high level decisions (including caps, targets, and changes to the EITE program) were to be taken by the Government of the day, mostly on the advice of periodic reviews by Government-appointed experts.

However, the work currently being conducted by the PC in assessing shadow carbon prices in selected sectors of certain major economies would be highly relevant to any future decisions around EITE assistance and possibly targets. It would be logical to continue and expand this work, developing a broader body of data and more accurate methodologies over time. Whether conducted by the PC or a new body, the role of this work in future decision-making should be clarified.

There is also support from various quarters for the idea that key decisions be taken by an independent body directly, perhaps with scope for subsequent Parliamentary review. This might cover targets, caps, changes to EITE arrangements, or disposition of other revenues and permits. Analogies include the role of the UK Climate Commission in setting and reviewing targets, or the interest rate-setting function of the Reserve Bank. Clear criteria to guide decisionmaking, appropriate review and the confidence of stakeholders and the public in any independent body would be vital to such an approach.

Option: Whether or not carbon pricing proceeds, the PC should be formally tasked with the further development of its shadow carbon pricing work, with appropriate resources. The scope of the work should ultimately cover all relevant competitor countries and all trade exposed industries, but the initial focus on EITE activities and the Major Economies Forum countries. The PC's role would be firstly to develop relevant data and methodologies; secondly to build links, exchange information and encourage a common approach with other relevant countries and organisations like the OECD; and thirdly, if carbon pricing proceeds, to be the key source of advice on whether the rate of assistance for any trade exposed activity should be varied.

Option: If carbon pricing proceeds, key decisions should rest with in an independent regulator whose decisions may be disallowed by either House of Parliament, with clear criteria for decision written into the legislation. The regulator should not sit within DCCEE, but be as independent as the PC or the various energy regulators. The decisions and relevant criteria would be:

- a) Whether to defer a transition to trading – the criterion for delay being, as suggested above, whether the regulator judges international carbon market volumes insufficient to meet Australia's needs;
- b) Emissions caps under trading – the criteria being consistency with Australia's international commitments and obligations, taking account of any measures for sectors not covered by the carbon price;
- c) Adjustments to EITE allocation, including increase, stabilisation or reduction, on an activity-by-activity basis – the criteria being the existence and level of any shadow carbon prices actually impacting relevant competitors in relevant countries for any given activity.

6. Associated issues

Place of RD&D in Government policy

Many agree that support for research, development and deployment of new low-carbon technologies was a gap in the CPRS. Some, including the Greens and Ross Garnaut, have suggested setting aside a portion of carbon price revenue for these ends.

Ai Group's climate policy principles state that support for research and development of new approaches to emissions reduction, and refinement of existing approaches, should be central to climate policy. However, scheme revenue is limited and subject to many high priority calls.

Option: RD&D could be funded from sources other than the funds raised by carbon pricing arrangements. Garnaut suggests that existing funds committed to this purpose, including for instance the Solar Flagships and CCS Flagships programs, should be sufficient for the next several years at least – though in some cases the programs involved can be improved and better implemented. Further investment public sector research funding should be directed to the development of emissions-reducing technologies.

Appropriate support for business investment in R&D related to emissions-reducing technologies is also required. This makes it all the more important that a full assessment and any necessary adjustments are made to the Governments proposals to change R&D tax arrangements.

Processes for removal of high cost abatement measures

Australian National Audit Office (ANAO) and Productivity Commission reviews have identified several hundred emissions abatement measures in place at the State and Federal levels. Most have a fairly high abatement cost and are unlikely to be complementary to a carbon price. While many are small grant programs and relatively few are explicitly regulatory, their collective cost to the public finances, energy consumers and business time is substantial. The most prominent and costly measure among these is support for renewable energy, and in particular the Small-scale Renewable Energy Scheme (SRES). SRES is likely to add \$6 per megawatt hour to electricity prices in 2011.

Ai Group's climate policy principles state that policy should drive the elimination and avoidance of unnecessary, duplicative and unduly burdensome climate regulation. They also state that complementary emissions reduction measures should be adopted only where they can achieve abatement at a lower cost than the primary market mechanism, or where they help markets to function more efficiently. Interim or temporary measures should be adopted only where they are consistent with long-term policy directions, have acceptable start-up and phase-down costs, and can achieve abatement at least cost, including on a net present value basis.

The Government has recently announced it would accelerate the reduction of the Solar Credits multiplier within the SRES, taking it from 5 down to 3 on 1 July 2011. It is that multiplier that was largely responsible for the unexpected and very expensive surge of activity under SRES. The more rapid removal of the multiplier, which will decline to 2 in 2012 and 1 in 2013, should quickly bring installation of household solar panels to more sustainable levels, and greatly reduce the impact on electricity prices. This is the sort of action that the Government should strongly pursue, and encourage among the States, to ensure the principle of least cost abatement is genuinely observed.

Option: If carbon pricing proceeds, the Government should commit to a strong, clear set of criteria, consistent with the principles outlined above, to define complementary and cost-effective interim mitigation measures. Such principles should go beyond the COAG Complementarity Principles agreed in November 2008, including by requiring that the carbon price underlying a potential measure should be comparable to that expected to apply in the main market mechanism over the life of the measure.

These criteria should be applied rigorously to all future policies and measures that aim (even partly) to reduce emissions, and measures that fail the test should not be adopted.

The Government should also review all existing mitigation measures, and progressively remove those which are not genuinely complementary to a carbon price.

Finally, the Government should negotiate an intergovernmental agreement with the States and Territories that commits them to strengthened complementarity principles and a similar process of review and rationalisation. This should include effective incentives for compliance and transparent review of progress.

The initial review of Commonwealth and State measures, as well as subsequent annual reviews of progress in rationalising existing non-complementary measures, and avoiding new ones, should be undertaken by an independent body. The PC is most appropriate, though the ANAO and Office of Best Practice Regulation may have much to contribute. Adequate resources will be needed.

Domestic offsets (non-Kyoto compliant, not for acquitting liabilities)

The Carbon Farming Initiative provides scope for creation of offsets from emissions reductions or sequestration that would not be recognised or credited to Australia under current Kyoto Protocol rules. Such offsets might be sold domestically or overseas for use in voluntary arrangements, but are not proposed to be accepted for compliance under an Australian carbon price. Some, including the Greens and Ross Garnaut, have suggested setting aside some scheme revenue to fund Government purchase of these offsets.

Ai Group's climate policy principles state that any emissions reduction measures should meet our international commitments at least cost, and that policy should be able to drive all credible and internationally recognised forms of abatement. At present non-Kyoto compliant offsets do not meet these tests. However, accounting rules may change; if and when they do, Australian providers, markets and methodologies need the experience and scale to ensure Australia can derive maximum advantage from the potential for relatively low-cost biosequestration. There may thus be a case for modest public funding for early emissions reductions, subject to other competing funding needs.

Option: If carbon pricing proceeds, then, subject to adequate funding for trade exposed measures, a small fraction of scheme revenue could be set aside for purchase of non-Kyoto offsets. An appropriate level might be half that proposed by Ross Garnaut – 1% initially, scaling up to 2% by 2020. Meanwhile efforts to reform international carbon accounting rules should continue. If these bear fruit and the rules allow a wider range of offsets to be counted, such offsets should be accepted to acquit scheme liabilities. In this event the amount of funding set aside to purchase non-compliant offsets should be reduced or eliminated.

Option: Whether or not carbon pricing proceeds, public purchases of non-Kyoto offsets could be made at modest levels sufficient to promote the further development of understanding and capacity in the land sector, funded from the broader Budget.

ATTACHMENT A

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. 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.

2. 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.

3. 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.

4. 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.

5. 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.



6 May 2011

The Hon Greg Combet AM MP
Minister for Climate Change and Energy Efficiency
Parliament House
CANBERRA ACT 2600

CPRS MEASURES FOR EMISSIONS INTENSIVE TRADE EXPOSED INDUSTRIES

Dear Minister

At the most recent meeting of the Transitional Assistance Working Group, the Australian Industry Group and the Business Council of Australia outlined the results of soundings we had taken from our respective members on the measures for emissions intensive trade exposed (EITE) industries proposed under the Carbon Pollution Reduction Scheme. These soundings followed a request from you at the previous Working Group meeting.

This letter lists the issues and perspectives that were raised with us about the CPRS arrangements as they stood at the end of November 2009. We emphasise that the items listed below does not represent the views of either of our organisations but records the variety of input from our members as you requested.

Our organisations are also separately preparing submissions on the overall design of the Government's proposed carbon pricing scheme, including measures for trade exposed businesses.

The issues raised with us fell into eight broad categories.

Activity definitions

Concerns were raised about particular activities that were unaddressed, or not satisfactorily addressed. Companies argued that:

- Activity definitions and allocation for cement milling, coke production from brown coal, briquette manufacture and liquefied natural gas should be resolved;
- With respect to liquefied natural gas, apportionment methodologies for the supplementary assistance factor should be resolved;
- Glass containers should be reassessed for inclusion in the highly EITE category, rather than the moderate category;
- Production of glasswool and rockwool insulation and autoclaved aerated concrete blocks should be reconsidered based on increasing trade exposure;
- Proper consideration of sugar was hampered by an inadequate approach to value add and lack of data from some industry players; these should be overcome;
- Iron casting fell below the lower threshold, but not by much; it would be significantly impacted by carbon pricing;
- Activity definitions were too arbitrary and unreflective of the true nature of operations, particularly in the plastics and chemicals sector; and
- Changed economic conditions, particularly the high value of the dollar, make it appropriate to allow the option of using different baseline years if existing activities are reassessed, or new activities assessed.

Permit allocation

A range of views were expressed about the free permit allocation under the CPRS, including:

- Allocation rates should be 100% of the product of actual production and historical industry average emissions intensity (with, some argued, an adjustment if evidence of price passthrough emerged);
- Allocations of 100% of actual liabilities, not averages.
- There was strong concern that the 94.5% allocation band not be reduced;
- Support for addition of a third tier for less intensive activities;
- Support for maintenance of the existing 94.5% and 66% bands, and addition of a third tier for less intensive activities;
- Allocation to trade exposed activities below the current moderate EITE threshold based on a sliding scale;
- A single rate of 94.5% for all EITE industries;
- A test based primarily on trade exposure, not emissions intensity; and

- Several companies emphasised the importance of free allocation or equivalent other measures for highly trade exposed industries below the 1001 tonne threshold.

Decay rate

Companies were broadly dissatisfied with the CPRS decay rate, with many proposing it not be included.

- Most argued the decay rate should be removed entirely;
- Some suggested the decay should only commence when relevant trading partners or competitors introduced carbon prices;
- Others suggested the decay commence only once an Australian scheme moved to floating prices and international linking, as these provide a measure of cost control;
- Others argued that the high and moderate EITE allocations should not decay below 90% and 60% respectively.

Point of liability

One company submitted that liability should lie with subsidiaries and not controlling corporations, and that liability in joint ventures should be apportioned as per respective shares in the joint venture.

Review

With respect to the review of the appropriateness of EITE decay rates, several companies argued that the onus of proof should be reversed: decay would cease for an activity unless it could be shown that 70% or more of relevant competitors had introduced comparable carbon constraints.

Facility level allocation cap

Many companies were dissatisfied with the cap on EITE allocations at 100% of actual facility liabilities.

- Most of these argued that the cap was entirely inappropriate, as it reduced incentives to become more carbon efficient; and
- Some argued that cap should be applied at the corporate level to allow management of unders and overs across the organisation.

Scope Three

Several companies argued that Scope Three emissions relating to natural gas should be addressed for all EITE activities, not just where the gas was sequestered in a product.

Broader issues

Companies also raised an assortment of issues that were of vital importance to them, but not easily characterised. These include:

- The need for recognition of passthroughs greater than 1 tonne CO₂-e per MWh in long term electricity supply contracts for large users, including those entered into, renegotiated or reviewed since 3 June 2007;
- Some smaller energy users were also concerned that they might face passthroughs greater than 1 tonne per MWh, particularly in Victoria;
- Concerns that local manufacturers of briquettes may be disadvantaged against importers (who may not provide accurate information on the fossil and renewable components of their product);
- Concerns that local manufacturers of automotive vehicles may be disadvantaged against importers who fall below the 25,000 tonne threshold and are thus not liable for their synthetic greenhouse gases;
- Concerns that fuel excise reductions proposed under the CPRS would relatively disadvantage biofuels;
- Concerns that the automotive sector was inadequately addressed by previous EITE arrangements;
- Concerns that some facilities perversely meet liability thresholds solely because of their installation of cogeneration as an energy and emissions efficiency measure;
- Some companies expressed a preference for a border adjustment and/or consumption-based approach to the trade exposure issue;
- Special arrangements for liabilities associated with first of a kind demonstration facilities; and
- A preference for a relatively low carbon price during the extended transition period.

Ai Group has previously written with suggestions for how impacts on trade exposed industries outside the EITE thresholds might be addressed.

Both organisations remain closely engaged in discussions of options and solutions for trade exposure issues.

Yours sincerely,

Heather Ridout
Chief Executive
Australian Industry Group

Maria Tarrant
Deputy Chief Executive
Business Council of Australia