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Emissions Reduction Fund Submissions
Safeguard Mechanism Branch
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AI GROUP SUBMISSION ON THE EMISSIONS REDUCTION FUND SAFEGUARD MECHANISM

The Australian Industry Group (Ai Group) welcomes the opportunity to provide feedback on the proposed Safeguard Mechanism (the mechanism) of the Emissions Reduction Fund (ERF). Overall, the proposed design appears to meet the Government's expressed intention that the mechanism should not be a driver of emissions reductions toward the current 2020 target, which it intends to meet solely through the ERF's purchasing activity, the Renewable Energy Target and other existing policies. By the same token, if the other elements of the Government's policy suite do not perform as expected the mechanism will not ensure that the 2020 target is achieved. Administrative and compliance burdens are both likely to be low under this design, subject to concerns outlined below.

The ERF as a whole has been designed around the current 2020 target, and Ai Group's submission focusses on the mechanism's operation to 2020. We note that the model will likely have to be revisited, in the proposed 2017-18 review or earlier, given the deeper post-2020 emissions reduction targets currently under consideration. While the mechanism appears likely to largely avoid imposing additional costs over the next several years, it also seems unlikely to deliver other outcomes. In the longer term the mechanism may well impose costs and drive some degree of abatement, though it is not yet calibrated for Australia's as-yet unsettled post-2020 emissions reduction commitments. We note that the potential extension and development of the mechanism as a driver of future abatement could be very complex and would require extensive consultation with industry.

Coverage

The threshold of 100,000 tonnes of annual Scope 1 emissions will limit the coverage and administrative costs of the mechanism. However, the focus on direct emissions appears likely to reduce the effectiveness of the mechanism. The safeguard makes

electricity generators responsible for emissions associated with changes in electricity consumption, which they have little ability to control. With energy users likely to substitute gas with electricity in coming years as gas prices rise, this disconnect could be significant.

The proposed approach to coverage of the waste sector would apply a baseline derived from historical emissions from all waste at a facility, including legacy waste, but judge performance against this baseline using only emissions from 'new' waste landfilled since 1 July 2012. This approach reconciles the government's objectives of avoiding penalising business-as-usual and keeping baselines as simple as possible. However, it appears likely to provide more emissions headroom for most waste facilities than for other kinds of business.

Baselines – general

The general approach of defining baselines based on the historic high point of emissions between 2009-10 and 2013-14 has the advantage of simplicity. It would provide some headroom to most covered facilities; however, even with the special arrangements proposed for the waste, resources and electricity sectors, it is possible that some facilities will exceed their baselines through business-as-usual activity. That is particularly likely after the first few years, since many facilities gradually increase production (and associated emissions) as a matter of ordinary business practice. This situation does not appear to be addressed by the major expansion approach discussed below. Many potentially impacted member businesses would like to see an option for an emissions intensity-based test to be applied. One way would be to allow the 'independent assessment' process discussed below to be extended to existing facilities beyond the resources sector. Such an assessment would cover both situations where production gradually increases while intensity is constant, and where intensity increases and decreases on a predictable basis as part of a cycle of capital equipment wear and repair.

The potential for baselines to be breached makes other mechanisms to manage and minimise costs very important, as discussed below..

The proposed approaches to changes in global warming potentials and facility reporting methods appear to provide a moderate amount of flexibility while limiting additional reporting. However, some businesses have consolidated multiple former facilities into one. It is possible, and certainly desirable, that the proposed provisions relating to changes in facility boundaries would allow the consolidated facility to use a baseline that is the sum of the former facilities' baselines. The Government should clarify that this interpretation is correct. The alternative would impose costs on businesses even where they have reduced total emissions across their operations or held them steady, simply because the distribution of emissions between facilities has changed.

The proposed minimum baseline amount of 100,000 tonnes CO₂-e is reasonable given the coverage threshold.

Baselines – investments underway

The approach to investments already underway appears to be of direct significance only to the mining, oil and gas extraction, and Liquefied Natural Gas export sectors, as these appear to be the only sectors with facilities likely to newly exceed the coverage thresholds before 1 July 2020. The approach would derive a baseline from the high point of production levels and operational emissions intensity expected by the facility operator, subject to some scrutiny by the Regulator and an external auditor. As proposed this approach could potentially minimise administrative costs and limit the likelihood of the baselines being breached.

The paper also proposes that this independent assessment process be made available as an option for resources facilities that may expect their emissions intensity to increase under business as usual. This should meet the concerns of resources facility operators. As discussed above, operators of other facilities may have similar concerns with the default baseline approach, either because they expect production to increase incrementally without triggering the major expansion rule, or because they expect intensity to increase because of the nature of their facility. The independent assessment option should be made available to such facilities.

However, while the emissions intensity estimation process is intended to meet the clearly expressed concerns of the resources sector and others, the potential also exists for the process to become more complex and contested than intended. This is particularly so for resources facilities with a declining resource, including existing facilities subject to the proposed special arrangement for the resources sector. Estimating future emissions intensities for such sites is complex and high levels of confidence may not be possible. Implementation needs to take care to avoid imposing unnecessary costs on affected businesses.

Baselines – new investments and significant expansions

The proposed derivation of future best practice standards from the average emissions intensity of the top 10% of existing Australian industry output is conceptually simple. In theory it would provide a standard that evolved over time in line with changes in industry practice. Since it would be derived from actually achieved practice it would act more to set a floor under future performance than to drive substantial further change.

However, this approach is likely to be challenging in practice. The paper appears to treat facilities, industries and activities interchangeably, but a facility may conduct a mix of activities that can be construed as part of different industries. The government expresses the desire to simplify the process of defining best practice, but simplicity and arbitrariness may mean that derived baselines have little relationship to ‘best practice’ and may introduce distortions. The focus on direct emissions means that a particular facility that uses grid electricity may be taken as a basis for ‘best practice’, and a similar facility using gas onsite may be taken as falling short – even though net national emissions from the latter facility would be lower. The use and adaptation of international data to substitute for a lack of Australian examples is likely to be complex

and contested, given many differences in the commercial, regulatory and energy context.

Assuming that best practice emissions intensity standards can be derived, the proposal to produce baselines by multiplying them by the highest expected level of production over the first three years of operation – and then by the actual highest level achieved in that period – is practical.

The proposal to define significant expansions as a 20% increase in production capacity, owing to the installation of new equipment, is inherently arbitrary but practically applicable. However, it is unclear whether the test could be met by gradual upgrades and production gains over several years, or requires a ‘big bang’ upgrade. Continuous gradual increases in production are the norm in many activities to stay competitive. Furthermore, an upgraded facility – even where the new equipment is at or above existing best practice – is unlikely to perform as efficiently as an entirely new facility. By adopting the same best practice standard as for new facilities, and applying it (as far as we understand) to the whole of the production of the upgraded facility, it is likely that the resulting baselines will disadvantage upgraded facilities compared to new facilities. Existing, upgraded and new facilities would all be conducting ‘business as usual’, but upgraded facilities would be more likely to breach their baselines. This may act to discourage upgrades.

Managing emissions

The proposed option for multi-year monitoring over up to three years is a reasonably simple way to address natural variation in emissions. However by rejecting an emissions intensity option – which we acknowledge would be complex to implement and appropriate for only some industries – the approach is eventually likely to disadvantage businesses that ‘creep’ production, unless they pass the 20% threshold. The requirement for ‘satisfactory evidence’ that emissions could be returned to baseline levels is potentially vague and may lead to arbitrary decision-making unless better encapsulated in the final regulations.

The option to use qualified carbon offsets to avoid an excess emissions situation is extremely important. It helps improve the environmental efficacy of the safeguard while containing the costs to industry of the mechanism, even under the design currently proposed, where baselines broadly carry a low probability of exceedance. Under any future evolution of these proposals, offsets are likely to play an even more important role in controlling marginal costs and evening them out across different liable parties.

Ai Group has long argued that international carbon offsets should be used by Australian climate policy to control costs. Under the legislation that enables the safeguard mechanism, such offsets are able to be approved through regulation. Given the strong supply, low price and high integrity of available offsets, including most categories of Certified Emissions Reductions issued through the UN Clean Development Mechanism, it makes excellent sense to allow access to these units. That would do a great deal to ameliorate industry concerns about imperfections in the

safeguard mechanism.

The proposed rule against double counting of emissions offsets generated by facilities subject to the mechanism is directed at a real need. However we note that as stated it would have the effect of strongly discouraging liable facilities from selling credits into a secondary market rather than to government, since the former could push them above their baseline while the latter could not. This evidently is the intention, but it would mean fewer options for other liable parties seeking to avoid an emissions excess.

Even with the potential use of carbon offsets, domestic or international, to minimise costs, the likelihood is that the current design will likely impose some degree of costs on businesses over time, particularly where production increases incrementally. It is important to note that many of these businesses will be trade exposed, and that the mechanism currently does not include any specific mechanism to address impacts on trade exposed industries. A highly emissions intensive and trade exposed facility may thus face a higher burden in several years' time than it would have under the former carbon tax, particularly on incremental production.

The proposed graduated enforcement options are procedurally reasonable and consistent with other areas of Commonwealth regulatory practice. However, a cost effective emissions constraint policy needs to provide a transparent, observable, reasonably predictable and efficiently set incentive across liable industries. It is important to be clear that in the current policy it is only the availability of emissions offsets that contributes to this requirement. If offsets were not formally available, or if the actual supply available were inadequate, the safeguard would likely impose uneven costs and create distortions.

Electricity sector

The paper proposes to treat the grid connected electricity sector as a single facility in the first instance, with a baseline set at the average of a historical period rather than its high point. Only if this sector-wide baseline were breached would individual facility baselines apply. Two options are provided for such individual baselines: one applying to all generators based on their average emissions during the same historical period, and another applying in the same way but only to those generators who are above the average emissions intensity of the sector.

The effect of the sectoral baseline is to delay the period in which baselines have any impact on the electricity sector. If the historical period used were 2009-10 to 2013-14, as used elsewhere in the policy, based on the Government's recent emissions projections the sectoral baseline would not be breached until 2017-18, with individual baselines applying from 2018-19.¹ However these projections assume that the Renewable Energy Target is reduced to a 'real 20 per cent' level, rather than the higher levels currently under negotiation. That makes it unlikely that the sectoral baseline would be breached before 2020.

¹ If the high point of emissions were used, as elsewhere in the policy, this point might not be exceeded until 2026, subject to considerable projection uncertainty.

It is unclear that the sectoral baseline could have other effects beyond delaying the onset of individual baselines, as it is transient and does not provide any mechanism for coordination of emissions activity across the sector; sectoral emissions will simply reflect the sum of individual activity. In that sense the proposal would initially meet the Government's goal of avoiding penalty to business as usual activity.

Once applied, individual facility baselines would likely be breached frequently and somewhat arbitrarily based on the fluctuations of supply and demand in the electricity market. Restricting this to generation facilities with above-average emissions intensity reduces the scope for distortions, though the equity implications are unclear and perverse outcomes remain possible between above-average and very high emissions intensity generators.

While the dynamics of the electricity market can be complex, it is likely that the costs of avoiding such breaches would add to generator bid prices and tend to add to costs for electricity users.

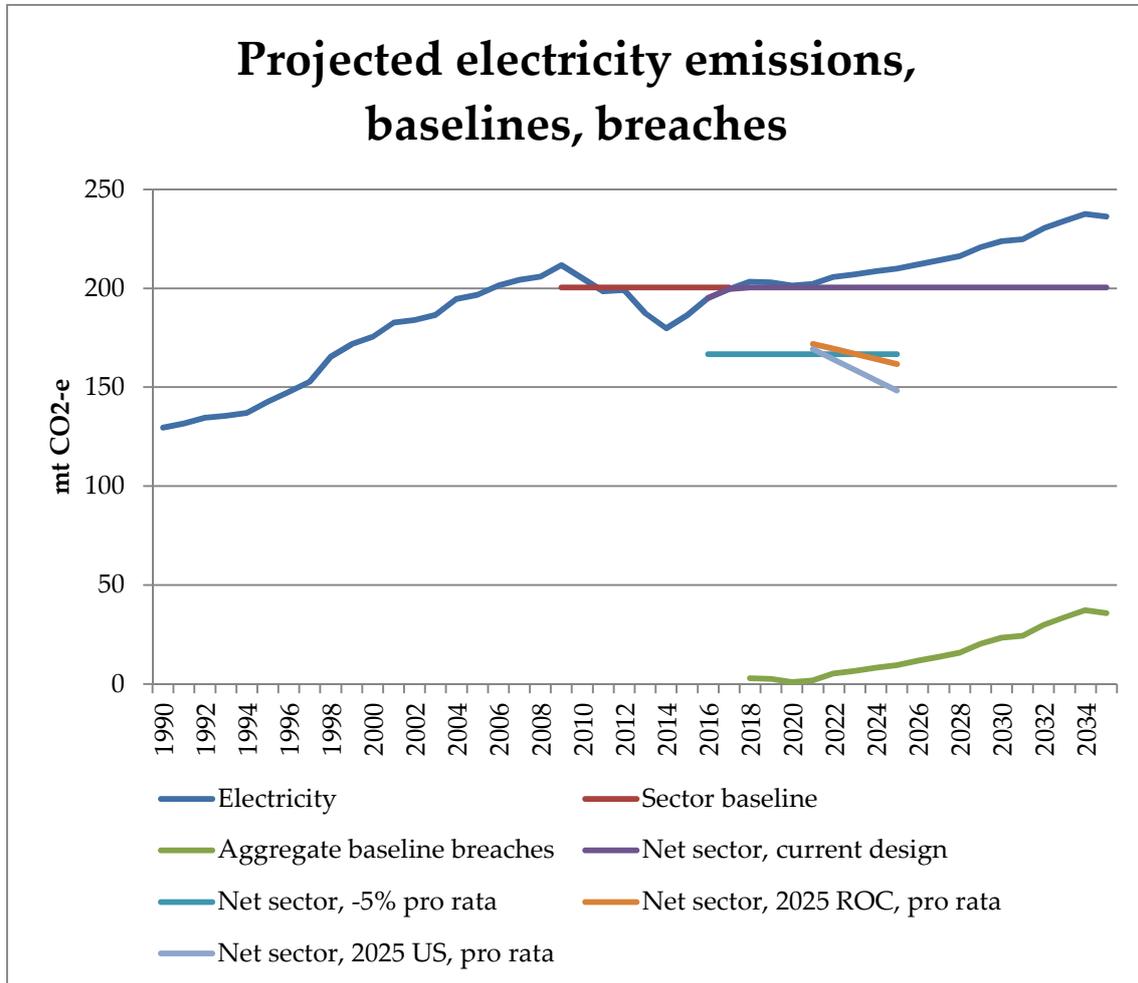
Applying similar coverage and management rules to the electricity sector as elsewhere is not problematic. The proposed approach to new investment raises important questions, however. The approach would apply a similar benchmark to other sectors, based on the top 10 per cent of Australian peers' emissions intensity. The intention to apply a technology-neutral best practice standard is well intended, though developing distinct benchmarks for baseload, intermediate and peak electricity is itself a reflection of a current technological environment that may be shaken by new developments.

However, it should be noted that it appears possible that such benchmarks may well be set at very low levels. At a minimum it is likely that all new baseload generation would face an emissions baseline set at the performance level of combined cycle gas turbines. Standards could be even tighter under the proposal as currently understood. For instance, hydroelectric dams can produce baseload electricity, while also varying output to meet intermediate requirements. Some can also ramp production rapidly to meet shorter demand peaks. It is unclear whether the Government intends to set baselines at hydroelectric levels. As noted in the paper, it is currently unlikely that the electricity sector will see any new generation capacity before the mid-2020s other than that brought on by the RET and other government policies.

The chart below sets out a very simplistic treatment of the proposed rules in light of current emissions projections (which are imperfect as noted) and does not incorporate new investment. It shows the sector baseline and the sum of projected breaches of individual facility baselines, assuming they apply to all facilities and not just the more intensive. It also depicts, purely for illustration, the implied sectoral emissions expectations if three potential post 2020 target options were applied pro rata to expected electricity sector emissions. In practice policy should pursue emissions reductions wherever they are cheapest across the economy to reach the overall goal, rather than seeking an equal reduction within each sector.

One of the options charted is a flat continuation of the current -5% target; another

assumes continuation of the rate of change required to meet the -5% target; the other is adoption of a target similar to the United States' -26% off 2005 levels by 2025. As for the general baselines, the electricity sector baseline system is calibrated to meet, at least for the next several years, the commitment not to penalise business as usual. It would need substantial revision if it is to play a role in future commitments.



Other matters

It is proposed that the Regulator publish, among other things, the baseline determinations and actual annual emissions for each covered facility. Previously the Regulator has only reported emissions at the corporate group level. The higher level of detail carries the potential to compromise commercially sensitive information and should be considered with caution.

The proposed review of the safeguard mechanism by the end of 2017-18 is sensible. While the system will not have been in operation for long and frequent reviews have proven counterproductive in other contexts, the difficulty of the design exercise and proximity of post-2020 emissions targets will make review necessary in 2017-18 or before. A review will need to involve extensive industry consultation, particularly if changes to the nature and purposes of the safeguard mechanism are proposed.

For any questions relating to this submission, the best contact at Ai Group is Tennant Reed (tennant.reed@aigroup.com.au, 03 9867 0145).

Yours sincerely,

A handwritten signature in blue ink that reads "Innes Willox". The signature is written in a cursive style and is underlined with a single horizontal stroke.

Innes Willox
Chief Executive