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Ms Kelly Pearce
UNFCCC Taskforce
Department of the Prime Minister and Cabinet

Dear Ms Pearce

AI GROUP SUBMISSION ON THE EMISSIONS TARGETS ISSUES PAPER

The Australian Industry Group welcomes the chance to provide input into the Federal Government's consideration of post-2020 emissions targets. This is an important issue, and one which will require extensive consideration and discussion – both for the formulation of the offer put ahead of the Paris negotiations, and in deciding in coming months and years on policies to meet the targets adopted.

Ai Group has developed strong principles for climate policy in consultation with our members, which go both to how Australia's efforts are calibrated and how policy is designed. The principles are attached to this submission. We have found considerable common ground on these fundamentals with other stakeholders across industry and civil society.

Overall, these principles go to ensuring that Australia's emissions reduction effort is in line with the action and ambition of other major economies; preventing the erosion of the competitiveness of Australia's trade exposed industries; meeting our international emissions reduction commitments at least cost; respecting existing investments and fostering efficient long term investment; supporting innovation; and minimising compliance and regulatory burdens.

While Ai Group does not propose a specific emissions target, we offer thoughts below on the nature of a target and implications of several illustrative targets. The Taskforce's proposal to look at Australia's national circumstances and the target offers of other major economies is sensible. In addition, it is worth considering the ultimate goal of climate policy and the long term strategic context.

Reducing global net emissions sufficiently to contain climate change to less than 2 degrees will take concerted effort by many nations, iterated and deepened over many years as and when

trust and experience grow. Australian targets should be chosen and developed to reflect and support that longer term effort.

The design of domestic climate policy is the major determinant of the costs of climate action, rather than the level of the target. This is particularly so for those costs related to the potential loss of competitiveness by trade exposed industries. Access to international abatement opportunities, which have tended to offer lower marginal abatement costs than in Australia, is a crucial opportunity to control costs. Such access can both lower national costs and decouple the extent of Australia's climate ambitions from the impact on trade exposed industries.

The design of Australia's longer term climate policies will take some time, though the current review can serve as a useful spark to debate. Whatever the mix of purchasing, regulatory and price instruments ultimately adopted, no policy will be effective without broad support from the community and across politics.

Specific questions

What should be Australia's 2020 target and how should it be expressed?

Base year

The choice of a base year for Australia's target commitment is more a matter of transparency than the inherent advantages of any particular base. Comparability with other countries and ease of understanding are the primary concerns. While Australia currently uses a 2000 base year, it may also be useful to express targets as a reduction from our peak emissions year. That was 2006-07; though this is close enough to the 2005 base year used by the United States, China and others to make 2005 a relatively useful base.

Comparisons to a business as usual (BAU) scenario are also of interest. However it needs to be remembered that BAU is a difficult concept (for instance, when do policies already implemented become part of BAU?), and in practice estimates of have proven highly unreliable, whether they deal with Australia or other economies. BAU should therefore be used with caution.

End year

While the European Union and related nations have put forward 2030 targets, the United States and others have made commitments covering 2021 to 2025. It would

make most sense for Australia to adopt a 2025 target, given the iterative nature of the international negotiations. The limited degree of domestic policy clarity and consensus should also encourage shorter-duration targets for now. However, we note that developing longer term guidance is going to be important for future investment in energy and many other areas – though guidance as to domestic policy will be even more important than guidance on targets.

Type of target

The target should be:

a. Absolute. Emissions intensity of GDP or other formulations can be useful analytical tools for assessing our own performance or that of other countries. However they are less clear than absolute measures, Australia has not used them before to express commitments, and they are not being used by other advanced economies.
b. Net. The target should be inclusive of sequestration and, crucially, of trade in valid international emissions rights and offsets. While we note that the unconditional commitments offered by other nations so far are not reliant on trade in international units, Australia's national circumstances make trade particularly crucial; we are a substantially smaller economy than the United States or Europe, with a greater potential for volatility and cost escalation without the stabilising influence of access to external sources of abatement or emissions rights. Trade will make targets cheaper to meet, enabling higher ambition without higher burdens.
c. Unconditional. Australia might choose to again offer both an unconditional minimum target, and additional deeper targets conditional on levels of international ambition, as it did prior to the Copenhagen conference. However, the frequent iteration of targets every five years will provide a more effective way to revise ambition in light of performance and participation than such further conditional pledges. Nearly all pledges by major economies so far have been unconditional, and few have included an additional level of effort conditional on further action by other parties. The nomination of additional conditional targets by many nations in the Copenhagen context was not notably successful, with nations generally not adopting the higher targets even where conditions were arguably met.

Level of target

Ai Group does not champion a particular target, and we regard domestic policy design as much more significant to shaping economic impacts than the level of targets. We

accept that Australia ought to bear a fair share of the global effort required to meet the 2 degrees goal, and note that 2025 targets are just a stepping stone towards that longer term context. Our national interests would not be served by taking on targets that imply a disproportionately high or low burden compared to the actions of other relevant economies. There are risks both from the excessive costs of an inadequately reciprocated target, and the diplomatic and potentially economic damage of a target perceived as too weak.

While the European Union has stated a target to reduce emissions 40% below 1990 levels by 2030, the United States' commitment to cut emissions 26%-28% below 2005 levels by 2025 is arguably a more important point to calibrate against given their economic weight, our relationship and the similar peaking of our national emissions in the middle of the last decade.

However abatement costs may differ between the US and Australia, for instance because of the difference in expected prevailing natural gas prices. Therefore an Australian commitment should be inclusive of trade in valid international emissions entitlements and offsets, which have the effect of levelling out national marginal abatement costs.

It should also be emphasised that the question of appropriate national effort is distinct from the issue of the competitiveness of trade exposed industries. The advanced economies against which we might compare ourselves for questions of national effort are by and large not the countries in which the chief competitors for our trade exposed industries are based; the latter include many emerging and developing economies in Asia and the Middle East. Whatever targets we arrive at after considering our peers, domestic policies aimed at meeting those targets should include measures to avoid unfair trade disadvantage that are calibrated against the policy settings that our competitors face.

What would be the impact on Australia?

Predicting the costs and benefits of any emissions target is extremely difficult. Past modelling exercises suggest that the impact of Australia's own emissions targets on our economy is less significant than the impact of other countries' targets and actions, which if ambitious and realised will tend to reduce prices and volumes for some of our exports, such as thermal coal (and potentially improve prices and volumes for some others, such as natural gas).

The cost of abatement will be affected by the availability of international trade and the rate of improvement in technologies such as renewable energy, energy storage and carbon capture and storage.

However the central factor is the design of domestic policy, which can potentially make any target considerably more expensive than necessary. Australia's pre-2020 emissions policies remain under development, and post 2020 policies are speculative at this point. In light of these matters, any cost estimates therefore need caution and can be indicative only.

Based on recent announcements, Australia's historical emissions and recent projections, and without endorsing any specific target, the following chart and table set out several indicative options for post 2020 targets and a simple estimate of their potential minimum costs. Briefly, those indicative options include:

1. Maintaining Australia's emissions at 5% below 2000 levels to 2025;
2. Continuing to 2025 with the rate of change required to meet the current target of 5% below 2000 levels by 2020;
3. Adopting the low-end US target of a 26% reduction below 2005 levels by 2025;
4. Adopting the high-end US target of a 28% reduction below 2005 levels by 2025; and
5. Adopting the EU target of a 40% reduction below 1990 levels by 2030.

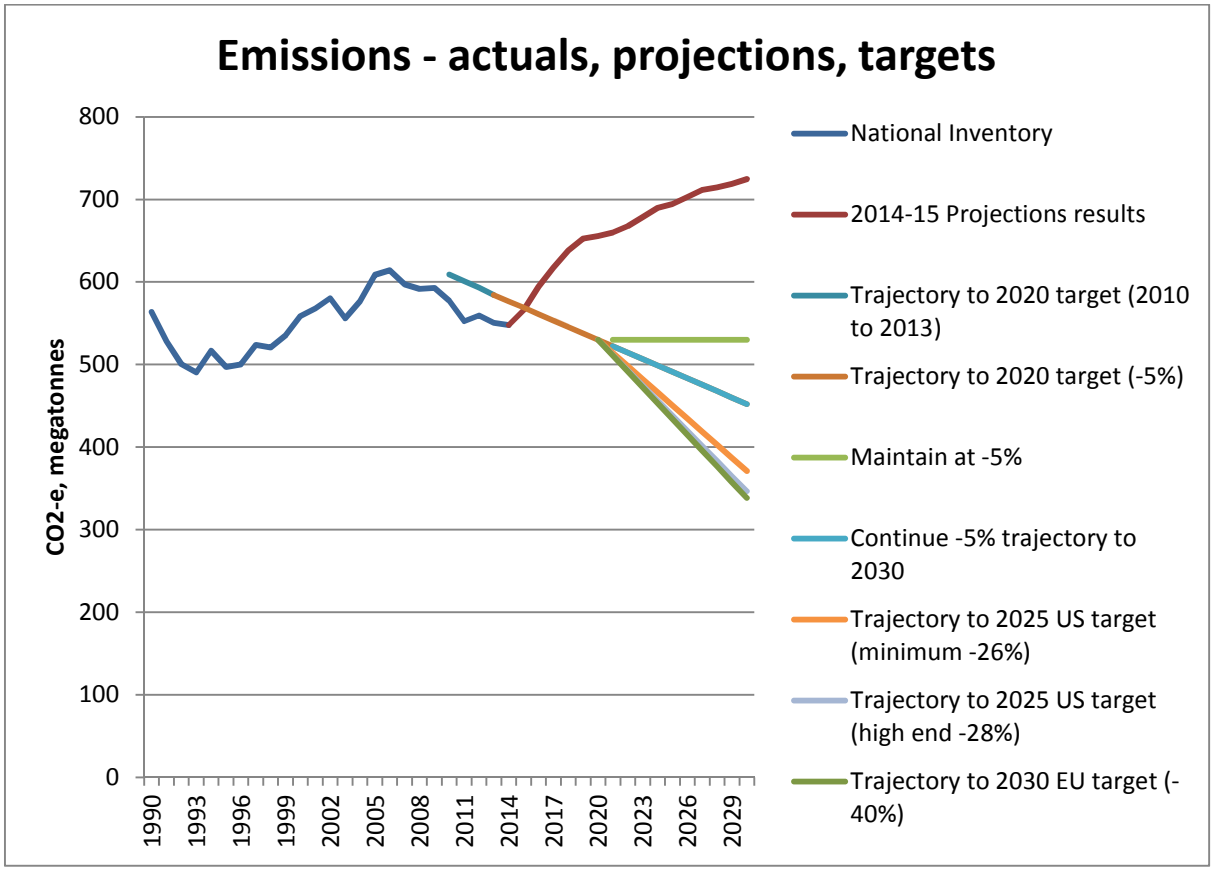

Table i - Indicative implications of potential 2025 targets

Indicative target	2025 emissions (% below 2000 levels)	2025 emissions (mt)	Cumulative abatement task (mt)	Indicative minimum direct cost NPV 2020-25[1]
Maintain -5%	-5%	530	740	$19 billion
Continue -5% rate of change	-12.1%	491	856	$22 billion
Adopt US low end	-19.4%	450	978	$25 billion
Adopt US high end	-21.6%	438	1015	$26 billion
Adopt EU target	-22.4%	434	1027	$26 billion

The estimates for cumulative abatement required, and hence abatement cost, are necessarily speculative, and are based on recent projections for Australia's future emissions in a business as usual scenario. It is worth remembering that the projections are heavily reduced from previous projections, and that any BAU scenario should be treated with great caution.

What further policies complementary to Direct Action should be considered and why?

The post 2020 policy suite will need extensive discussion and development, both to ensure efficient policy and to attain the broad support needed for policy stability.

The shape of Direct Action itself beyond 2020 remains under development and will need review. Purchasing abatement post 2020 in volumes consistent with any of the indicative targets considered above would require, at a minimum, very substantial new Budget commitments, which would likely grow strongly. The safeguard mechanism design outlined in a recent discussion paper meets the Government's objective that the mechanism will not be a driver of abatement towards the 2020 target, but would need substantial amendment to play a role in the effort towards post 2020 targets. The development of best practice standards for new facilities is important to the current design, but likely to be fraught with difficult questions and contentious judgments.

[1] This calculation is purely indicative, based on assumed abatement costs starting at $30 per tonne in 2020 escalating to $45 in 2025, applying a 5 per cent discount rate and assessing net present value of costs as at 2015. Estimates of future marginal abatement costs vary widely. As discussed elsewhere, domestic policy design will heavily influence the actual costs of achieving any target. This calculation does not include impacts from other countries' targets and their influence on demand and price for Australia's exports.

The additional regulatory policies suggested by the current discussion paper as potentially complementary to Direct Action – a range of efficiency standards and measures to reduce synthetic greenhouse gases – may be worth considering but would need extensive development and consultation before adequate judgments can be made about their net benefits and relative value. Development of a wide range of distinct policies for different sectors, technologies and abatement opportunities raises the risk of poor coordination and unnecessarily high costs.

While State governments have a role to play in relevant policy areas, including the land sector and infrastructure development, the potential for multiple overlapping and inconsistent policies across different jurisdictions would compound these risks.

There is a value in broad based national policies with a mechanism to coordinate abatement activity and emissions choices against a common level of carbon constraint.

Should the Taskforce wish to discuss these matters further, the best contact at Ai Group is Tennant Reed (tennant.reed@aigroup.com.au, 03 9867 0145).

Yours sincerely,

Innes Willox
Chief Executive

ATTACHMENT

Ai Group Climate Policy Principles

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

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

1. Australia should ensure that its emissions reduction effort is in line with the action and ambition of other major economies.

This includes taking into account the extent to which major emerging economies are constraining their emissions and whether efforts by advanced economies are comparable to our own.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

including renewable energy technologies and carbon capture and storage, require significant support through demonstration and deployment phases if they are to achieve their potential.

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

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

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

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