AUSTRALIAN INDUSTRY
GROUP

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

ABN 76 369 958 788

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

Committee Secretary
Senate Standing Committees on Environment and Communications
PO Box 6100
Parliament House
CANBERRA ACT 2600

Dear Secretary

The Australian Industry Group has been closely involved in the climate policy debate for some years, and we are happy to assist the Senate Standing Committee on Environment and Communications in its inquiry into the Government's proposed Direct Action policy. However, given the relatively recent release of the Government's Emissions Reduction Fund Green Paper, we have not had an opportunity to fully consult our membership on the latest proposals prior to the closing date for submissions. We therefore emphasise that the points made at **Attachment A** represent a short preliminary reaction to the policy as currently understood. Ai Group will be in a position to make further judgments after deeper industry consultation in the coming weeks.

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

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

These principles are central to our consideration of all climate policy proposals, including the Emissions Reduction Fund and any other elements of the Government's Direct Action plan.

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

Yours sincerely,

Innes Willox
Chief Executive

ATTACHMENT A

INITIAL OBSERVATIONS ON THE EMISSIONS REDUCTION FUND

Capability of Direct Action

The Terms of Reference ask whether the Direct Action Plan has the capacity to deliver greenhouse gas emissions reductions consistent with the global 2 degree goal, and whether it can reduce emissions cost effectively. There are several points that should be made in response.

First, it is still difficult to be definitive in relation to the potential outcomes of a policy that remains very much under development. The Emissions Reduction Fund Green Paper is a welcome step in the policy process, and Ai Group looks forward to further consultation with the Government, including through our participation in the Expert Reference Group. However, the Green Paper largely canvasses possible pathways for developing the policy, rather than adopting firm new positions on policy detail. More definitive assessment must await the further articulation of the policy.

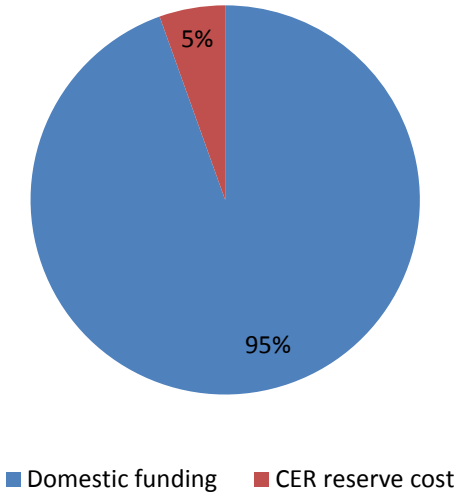
We also note that the ERF, the central element of the Direct Action plan, is currently structured and funded to pursue the bipartisan unconditional target of a 5% reduction on 2000 emissions levels by 2020. The Government has suggested that if it considered conditions around deeper targets were met, it would be open to policy refinements to assist this – in particular, the purchase of international emissions rights and credits.

That said, our initial impression is that the ERF has several challenges to overcome in order to achieve the Government's emissions reduction goals at least cost to Australia. The ERF has two broad elements: a system of reverse auctions for purchasing abatement from willing sellers, and a system of emissions baselines for large emitters involving a penalty for emissions above business as usual. Both systems are currently exclusively focussed on abatement taking place within Australia's borders. However, it has long been clear that Australia has relatively high costs for abatement compared to many other countries, owing to the nature of our energy resources and our strength in relatively emissions intensive industries. Access to international abatement options is critical for reducing the costs and risks of Australian emissions reduction ambitions. This is particularly so when, as is currently the case, the market price of overseas abatement is depressed below already low long-run costs.

Ai Group has argued that the Government should incorporate international emissions credits into its policy. The Green Paper suggests the possibility that businesses exceeding their baselines could make-good the excess through purchase of carbon credits, possibly including international ones. That could be positive, though our assessment depends on further elaboration of the baseline proposal. However, the best way to incorporate an international link within the Government's policy framework is for the Government itself to purchase international carbon units. These could be set aside against the risk that domestic abatement projects do not deliver sufficient emissions reductions.

The cost of such an insurance policy would be modest in the context of the ERF budget. The Government has committed $1.55 billion to the ERF from 2014-15 to 2016-17, and indicated likely spending of around $1 billion per annum thereafter – suggesting around $4.5 billion to 2020. At current prices of around $0.5 per tonne, it would cost just $250 million to purchase enough UN Certified Emissions Reductions (CERs) to cover, if need be, the entire projected cumulative emissions gap between a business as usual scenario and the unconditional -5% emissions commitment. That would leave considerable funds available for domestic activity, as illustrated by Figure 1 below. It should be stressed that these credits are internationally recognised and valid for meeting Australia's commitments. A strong CER supply is available at a very low price, largely due to a faster than expected reduction in emissions in Europe, the biggest market for CERs.

Figure 1 - Cost of full CER reserve as share of ERF funds to 2020



In the absence of such an insurance policy, performance against the targets depends primarily on the performance of the auctioning and baselining mechanisms. The Green Paper confirms that the baselining system is conceived as a safeguard, rather than itself a mechanism for driving abatement. That leaves the focus on the auctions. However, it is not yet clear whether the auctions will attract sufficient interest from potential bidders in industry and elsewhere. One worry relates to the statement that the Government will contract for abatement over a maximum term of five years at a time. Since most abatement projects will involve substantial upfront investment producing abatement over a much longer period, potential bidders would need either to increase their bid price to ensure total project costs are recovered within the initial five year window; avoid the auction; or run the risk that they do not get a further contract in later years, whether because they are uncompetitive at auction or because the policy framework has changed. Potential bidders would be reassured and more likely to participate if the Government signals clearly that it is willing to pay a high enough price to cover project costs and a reasonable return within a five year window, and that the auction framework will allow bids along these lines to be competitive.

An additional worry relates to the 'make good' requirement for successful bidders who fail to deliver the contracted abatement. Government understandably wants to minimise its risks; if

contracted projects do not deliver, government might face higher costs than anticipated to secure alternative abatement, or be unable to source sufficient abatement in time to meet its own commitments. However, make-good transfers these risks to bidders; this would make participation less attractive and likely increase bid prices.

Government has better options to manage these risks. These should involve emphasis on pre-qualification assessment prior to auctions to weed out weak proposals; non-payment for non-delivery; purchase of international units to cover delivery shortfalls at lower cost and with greater certainty; and a risk based approach to auction volumes, allowing the Regulator to contract for a larger volume of abatement than needed on the assumption that some will ultimately neither be delivered nor paid for. Taken together, these measures would eliminate the Government's financial and abatement risks without discouraging bidders.

An alternative, retaining a make-good requirement but allowing proponents to meet it using international carbon units, is worth considering as a second best. As long as proponents submitting CERs were paid a CER-pegged price, this would eliminate the difference in financial risk for proponents between make-good and non-payment approaches. However, making proponents the middlemen for CER purchases would not make the government any better off compared to direct purchases, and overall transaction costs are probably minimised if government manages the whole purchase of CERs itself.

If the next iteration of ERF development confirms that bidders will be able to recover their full project costs within a five year timeframe, and that the risks of make-good to proponents will be neutralised, participation is much more likely. The volumes of abatement that might be offered, and the prices that may be expected, remain unclear. Hedging the risk of underperformance with a reserve of CER purchases would be sensible.

Issues in establishing baselines

The potential for baseline-setting to create significant administrative costs for business and government has been a concern for some time. Preventing an erosion of competitiveness and minimising administrative burdens are crucial principles of climate policy. However, the initial proposals in the Green Paper significantly reduce this concern. Setting absolute emissions baselines for existing facilities using the high point of reported NGER data for each facility is likely to be nearly automatic and cost-free. This is in contrast to the much more extended and expensive process of developing industry average emissions baselines for the Emissions Intensive Trade Exposed program in the carbon pricing and renewable energy policies.

Past improvements to operations in response to high energy prices, combined with reductions in output in many emitting sectors, mean that businesses in most sectors are unlikely ever to breach a historic high point absolute emissions baseline in the absence of a major expansion, which would trigger a different 'best practice' test. However, it is likely that resources industry facilities could breach such baselines with business as usual practices, since mines tend to become more emissions intensive over time as the easier deposits are extracted. Furthermore, some facilities in other sectors could breach baselines through ordinary commercial responses to changing energy prices; in particular, a 'gas-to-coal'

switch is likely in the eastern states in response to the dramatic rise in gas prices now underway, driven by Liquefied Natural Gas exports. Further elaboration of the treatment of these instances is necessary.

While the setting of initial baselines for existing facilities looks much simpler than anticipated, several major questions remain. One is whether and how baselines might evolve over time. Another concerns how to establish 'best practice' for new entrants and major upgrades in a wide diversity of potential sectors. This still has the potential to be a costly and difficult process. The Government's commitment to additional consultation on the safeguard mechanism is welcome, though even a 2015 start date for this element may be too ambitious.

However there is a more fundamental question about the purpose of the baseline system. It does not look likely to penalise most emitting businesses, but nor does it serve an apparent function:

- the baselines are expressly not intended to drive reductions below business as usual;
- as Ai Group has previously argued, by definition policy is not needed to maintain business as usual behaviour; and
- the baselines do not look well adapted to preventing abatement purchased in one part of the economy from popping up as emissions in another part, since baselines will be set above current emissions levels for most businesses, and will leave much of the economy uncovered due to sector or thresholds.

While the proposal for absolute historic baselines reduces worries about the system, in the absence of a clear and compelling rationale for the use of compliance baselines and a proposal capable of achieving that intent, Ai Group questions the need for this element of the policy.

Policy certainty

Supporting efficient long-term investment is an important principle for climate policy. While industry is used to dealing with risk and change, a clear, stable policy framework with broad political support would make sound investment much easier. Financial commitments from government should also be as stable as possible.

The electricity sector is usually seen as most in need of a sound framework, given the risks of large stranded assets if investors guess wrong about future policy. However in the National Electricity Market the climate policy certainty issue now looks less urgent for the remainder of this decade. Falling demand for power means no major investment in generation is likely to be needed until the 2020s, other than that required by the Renewable Energy Target. This suggests some breathing space to put a long-term policy framework in place without incurring an elevated risk of stranded assets in the meantime, at least in the electricity generation sector.

With respect to the ERF, it will be very important to establish the credibility of the funding available, since this funding is the sole driver of abatement in the policy as currently understood. Announced budget funding commitments have a long history under all governments of being regularly modified, cut and reallocated in light of subsequent fiscal pressures. While businesses that reach funding agreements or sign contracts with government can reasonably rely on these, certainty about the future availability of announced but uncommitted funds is crucial to inducing business to prepare bids. And it is particularly important to businesses who might consider a business model of repeat transactions as an aggregator or service provider to projects. Such participation is crucial to maximise bid volumes and lower transaction costs.

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

- establishing a Special Account for the ERF;
- embedding an appropriation for ERF funding in an ERF Act rather than through regular Budget Bills; and
- giving the program administrator (the Clean Energy Regulator) discretion to expend these funds consistent with a strategy to meet an overall abatement task to 2020, rather than inflexibly adhering to spending levels or abatement goals for individual years.

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

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.