

# **HYDRO TASMANIA**

Submission to

**EMISSIONS TRADING WORKING GROUP  
SECRETARIAT**

**Background Paper for Stakeholder Consultation**

November 2005

## Guiding Principles

Hydro Tasmania is supportive of the move to establish a National Emissions Trading Scheme (NETS), providing a price signal locked to carbon emissions. We believe that it is an important first step in placing Australia on a long term path to a sustainable and lower carbon economy.

Core principles considered important to underpin the Scheme are detailed below:

- The NETS should create an environment where energy sector investors are able to rely on market pricing signals and hedging mechanisms to manage carbon price risk within industry investment cycles and timeframes;
- The Scheme should be implemented across all Australian jurisdictions in a consistent manner;
- The allocation of permits be determined by thorough analysis of various allocation processes used internationally with a view to encouraging genuine abatement activity and encouraging zero emissions generation such as renewable energy;
  - There should be explicit mechanisms to offset the impact on the competitiveness of trade exposed companies, taking into account their particular circumstances;
  - There should be explicit mechanisms to offset impacts on Tasmania which already has very low emission intensity yet could face economic and social impacts;
- That offsets include renewable energy projects subject to agreed additionality protocols and potential linking with other international schemes;
- New or incremental expansion of existing operations based on zero or low emissions technologies should be favoured and certainly not be disadvantaged;
- NETS market participants should have adequate time to prepare, in particular to establish systems and to develop response strategies and associated competencies;
- The Scheme must be designed in a manner that would enable future integration with emerging international Schemes such as the European Union Emissions Trading Scheme (EU ETS) and the US Regional Greenhouse Gas Initiative (RGGI);
- The Mandatory Renewable Energy Target (MRET) should not be changed by this scheme; and
- An interim support mechanism for the renewable energy industry should be implemented.

## Response to Design Propositions

### Proposition 1

**That a cap and trade approach be used as the basis for scheme design.**

Hydro Tasmania agrees that the cap and trade approach should be the basis for design of a NETS given:

- The demonstrated success of the approach in reducing US SO<sub>2</sub> emissions (US Acid rain programme);
- The precedents set and experience learnt through the EU ETS and potentially in the future by the US RGGI;
- Its certainty in providing environmental outcomes; and
- Its compatibility with international cap and trade approaches including the EU ETS and emissions trading under the Kyoto Protocol.

***To what extent does an Australian scheme need to be consistent and compatible with other schemes internationally (and therefore facilitate linking to those schemes)? What elements of a cap and trade scheme are required to ensure compatibility with other international schemes?***

An Australian NETS needs to be consistent with appropriate principles of key international schemes (such as the EU ETS) to the extent that it would allow integration at an appropriate time in the future.

In particular, integration needs to ensure reciprocal recognition of tradable permits and offsets.

***What are some of the opportunities and risks associated with linking to other international schemes? Is it possible to take advantage of the opportunities, while minimising Australia's exposure to the risks involved? How might this be achieved (eg. through single desk export arrangements)?***

International linkages open up a wider pool of abatement and access to a wider, deeper and more liquid carbon market, thereby reducing the overall cost of compliance across all participating jurisdictions.

In the interests of preserving market integrity, there should not be any restrictions on carbon trading between jurisdictions.

It is possible that a transition period would make sense to provide an appropriate glide path to participation at the international level.

Any integration with international schemes such as the EU ETS and US RGGI must be done in a manner that does not competitively disadvantage Australian industry competitiveness now or projected in the future.

***What elements of the European emissions trading experience should be taken into consideration in establishing the broad framework of the scheme?***

The most important lesson from the EU ETS implementation experience is that Scheme rules, mechanisms and supporting infrastructure must be in place well before commencement in order that participants are able to develop and implement considered responses, and establish the necessary modelling systems to manage the risk of entering a new market.

**Proposition 2**

**That the scheme be national and sector based.**

***Is national consistency an appropriate goal?***

National consistency is an essential prerequisite for an efficient NETS.

This must encompass:

- Permit allocation processes;
- Scheme rules, systems, processes and methodologies; and
- Supporting institutional and regulatory structures.

***Are there any jurisdictional variations that could be considered that do not undermine the desire for national consistency?***

The implementation of transitional arrangements (proposition 9) to protect the competitiveness of trade exposed companies should be progressed at a jurisdictional level.

There may be merit in providing greater jurisdictional discretion in this regard where such companies have a significant impact on jurisdictional economies.

There is potential for inequitable impacts at a jurisdictional level. For example Tasmania has very low emission footprint, yet will face marginal cost of emissions abatement and consequently have significant economic impact.

***Could a system operate effectively without all States and Territories involved?***

The minimum requirement for the establishment of a cap and trade scheme as proposed is the participation of all National Electricity Market (NEM) States.

The non participation of a single NEM jurisdiction would distort the competitive dynamic of the wholesale electricity market, and make a cap and trade scheme unworkable where liability was placed at the source of emissions.

***What institutions would be required for a nationally administered scheme?***

The key institutions required to administer a NETS are:

- A governance body, made up of jurisdictional representatives, with responsibility for establishment of the Scheme rules and future enhancements.
- A Scheme Administrator, with responsibility for all operational functions, including:
  - Administration of liability – comprising liable parties and implementation of rules for calculating and reporting emissions;
  - Administration of permit distribution – comprising permit allocation processes;
  - Management of permit and offset registry;
  - Administration of offset projects – comprising offset project accreditation and offset creation;
  - Scheme performance reporting; and
  - Consideration and ultimately integration with an international program.

In addition, consideration needs to be given to the establishment of two other independent functions:

- A disputes resolution body to facilitate speedy resolution of disputes relating to rule interpretation, including provision for an appeals process; and
- A Scheme auditor.

Finally, an independent agency would be important to monitor and conduct surveillance of the trading market, and to enhance the development of an open, transparent, liquid and efficient set of spot and forward markets.

**Proposition 3**

**That in setting the cap, consideration be given to the overall national emissions abatement target, and how the abatement responsibility is allocated between sectors covered by the scheme and those outside the scheme**

***How should a cap for the stationary energy sector be set? And how should it relate to an economy wide emissions target? How should the abatement potential of the non-covered sectors be taken into consideration in setting the cap for the stationary energy sector scheme?***

The establishment of the emissions cap is the most significant design element of the Scheme.

If the primary objective of the Scheme is to place Australia on a long term glide path to a lower carbon intensity economy, the cap for the stationary energy sector must reflect this imperative.

The emissions cap must therefore reflect a national commitment to achieve significant emissions reduction by the middle of the century.

***Should scheme caps and/ or economy wide targets be set beyond the first commitment period of the Kyoto Protocol? For example, are medium to long term scheme caps and/ or economy wide targets an appropriate means for providing investment certainty? Are there other means of providing reasonable certainty for investors and what are their relative merits?***

***Given uncertainty about what the level of possible future international targets for emission reduction [will be], how far should governments go to provide certainty for investors? To what extent might certainty for investors be at the expense of appropriate flexibility for governments?***

If the Scheme is to provide a long term investment signal, it must be supported by a long term emissions target path. The time horizon should extend beyond the first commitment period of the Kyoto Protocol.

The target should take into account;

- The present findings of climate change science, and the imperatives they present;
- The level of emissions reduction required for Australia to compete in a low carbon intensity world;
- The quantum of abatement achievable with current technologies; and
- The timing for commercialisation of emerging and new low emissions technologies.

***How can the scientific and political uncertainties best be incorporated into setting of the cap to ensure that future governments are not faced with unreasonable carbon liabilities?***

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The risks arising from scientific and political uncertainties should be accommodated through periodic review processes and a focus on keeping the NETS as simple as practical.

**Proposition 4**

**That the scheme initially covers the stationary energy sector**

***How should the stationary energy sector be defined?***

The stationary energy sector should be defined in a manner that is consistent with the National Greenhouse Gas Inventory, with appropriate adjustments to reflect the desired number of Scheme participants. This should include renewable energy generation.

***Where would the most effective and efficient points to place emission liabilities for the different stationary energy sub-sectors (ie. gas, electricity etc.) be – at point of emission, upstream or downstream?***

There are three points at which liability can be placed.

- **Upstream** – at the point where fossil fuels are produced (i.e coal, gas and liquid fuel production and/or importation);
- **Source of emissions** – at the point where emissions are created; or
- **Downstream** – on energy retailers, wholesale market participants and major users.

Placing liability upstream would result in increased fossil fuel prices being passed through the energy supply chain. However, as there are no direct signals for emissions abatement at the point of generation, it would be less efficient in facilitating reductions in generation sector emissions than would be the case if liability were placed directly at the source of emissions.

The case for placing liability at the source of emissions is compelling, as it provides **direct** incentives for emissions abatement within the generation sector and the shift to lower greenhouse intensive generation technologies.

Emissions associated with gas combustion by non liable parties could be captured by placing liability on gas retailers.

The major weaknesses of placing liability downstream are that it would not lead to abatement upstream or at the source of emissions, and that it would not facilitate a move towards less greenhouse intensive electricity generation, both being critical aspects of efficiency in any Scheme to constrain energy sector emissions.

This would therefore rule out the adoption of a Scheme similar to the present NSW Greenhouse Benchmarks Scheme.

The principle point of liability should therefore be at the source of emissions – wherever this may be. Careful definitions will be needed to clarify the boundaries of

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the source of emissions for example coal seam methane is produced upstream. By making the drivers more direct the NETS is more likely to have the maximum impact on emissions reduction.

***Should non-emitting energy generators (eg renewable energy) be included in the scheme as they will not incur a liability?***

Renewable energy generators must be designated as participants in the Scheme in order to participate in the permit allocation process.

**Proposition 5**

**That the scheme cover all six greenhouse gases under the Kyoto Protocol**

Hydro Tasmania supports the intent to cover all six greenhouse gases under the Kyoto Protocol.

**Proposition 6**

**That permit allocation be made on the basis of a mix of administratively allocated and auctioned permits, with both long and short term (annual) permits**

Hydro Tasmania supports the principle of allocating a mix of short and long term permits, on the basis of a mix of administrative allocation and auctioning. Administrative allocation should be gratis.

***What criteria should be used to select the method of allocation (eg. equity, market efficiency, cost minimization etc.)?***

Allocation should be guided by equity and economic efficiency considerations. Allocation of permits should be determined by a review of various allocation processes used internationally with a view to encourage abatement activity and encouraging zero emissions generation such as renewable energy.

In terms of equity, there should be explicit mechanisms to offset impacts on Tasmania which already has very low emission intensity yet could face economic and social impacts.

In terms of economic efficiency there should be explicit mechanisms to offset the impact on the competitiveness of trade exposed companies, taking into account their particular circumstances.

***How long should permits be allocated for? One year or more? And why?***

***If permits were to be allocated by emissions intensity benchmarking, what sectoral output or benchmark data is available (eg market share) to inform such allocation?***

***Does ‘benchmarking’ (or free allocation on an industry benchmark) disadvantage existing entities?***

***Should existing and new entities be considered differently in allocation of permits?***

***If permits are auctioned or allocated at a fixed cost, to what purpose should the collected revenue be put?***

Long term permits, which allow the holder to offset liabilities associated with a defined quantity of greenhouse gases for a specified period, provide long term certainty. Their value also lies providing a market indicator for the long term cost of abatement. For example, the market price of a ten year permit as specified above would provide an indicator of market expectations of the average cost of abatement over the period of the permit (in the same way that a ten year bond provides information on long term interest rates).

In contrast, short term permits should be issued on an annual basis.

The permit allocation process must ensure that new greenhouse efficient entrants are not disadvantaged.

In addition, there should be further exploration of how the allocation process could ***proactively facilitate*** investment in low emissions technologies including increased deployment of renewable energy.

Any revenues received through the permit allocation process should be deployed to supporting the development of the market and development and commercialisation of new renewable and low emissions technologies industries in Australia.

### **Proposition 7**

**That a penalty should be set to encourage compliance and to establish a price ceiling for the permit market**

***What penalty level is likely to be needed to achieve significant emission reductions from the stationary energy sector and ensure compliance of liable parties?***

Penalties must be set at a level that encourages compliance, without broad detrimental impacts on the economy.

A punitive penalty, such as that adopted in the EU ETS would provide greater certainty that the target will be achieved. However, the consequent pass through of high carbon prices could have a potentially substantial impact on industry and the economy.

The penalty level should therefore be regarded by Government as a device to cap the maximum impact of the scheme on industry participants but encourage technically and commercially viable abatement.

Compliance is ultimately dependent on whether the required level of abatement (to meet the target) exists at marginal costs less than or equal to the penalty. A pre-requisite to achievement of the target therefore is that the required technologies be

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technically and commercially viable within the carbon price range implied by the penalty.

Some emerging and next generation technologies (for example Hydrogen) will require other policy measures to ensure their commercialisation and widespread deployment. Emissions trading will assist, but will not guarantee their appearance.

The penalty level should therefore be set at a level that:

- Caps the impact on industry at a level that does not compromise economic development and growth;
- Reflects the magnitude of technically and commercially viable abatement; and
- Begins to place Australia on a glide path to a lower emissions footprint.

***What level of price certainty is desirable? Should a penalty be used to cap prices? If so, what level should it be capped at (for example, how high should a price cap be set in relation to the marginal cost of abatement)?***

Whilst price certainty is important to industry a cap should not be seen as a mechanism to set price and provide certainty. It should provide an incentive for market forces to set the price. The penalty level should be set higher than the marginal cost of technically and commercially viable abatement, to encourage abatement rather than payment of the penalty.

***What precedents are there for penalty levels in similar schemes (domestic and international)? Should the penalty be set to be consistent with other Australian schemes (eg the Mandatory Renewable Energy Target or the NSW Greenhouse Gas Abatement Scheme)? Should the level of the EU penalty be taken into consideration to allow for possible future linking with the EU trading system?***

The two most notable cap and trade schemes – the EU ETS and the US SO<sub>2</sub> trading Scheme opted for punitive penalties.

The NSW Greenhouse Benchmarks Scheme has penalties based on the marginal cost of abatement while the MRET penalty has worked with trading at a lower level than the penalty with high levels of compliance.

While the Scheme penalty does not necessarily have to be consistent with the penalty levels for these schemes, it is hard to see how Australian costs would not be aligned with international levels in the long term.

***Should there be a make good provision?***

There should be a make good provision to act as a deterrent to non compliance.

***What precedents are there for 'make good' provisions and what are the consequences for linking? If a make good provision is not included and the system is linked to other international schemes, how can 'bleeding' of***

***Australian permits be avoided (ie. significant buying of cheaper permits, leaving the Australian market with insufficient permits to offset liabilities)?***

The EU ETS features a make good provision, which could be used as a starting point for developing an appropriate model for Australia.

The MRET scheme has a make-good provision in that it allows refunding over a 3 year period of any shortfall monies paid by liable entities if they submit certificates to cover their shortfall.

***Should penalties be indexed or internationally linked? How often should they be reviewed?***

Penalties should be indexed to CPI, and reviewed every 5 years

**Proposition 8**

**That offsets be allowed**

***What sectors provide opportunity for inclusion through offsets – eg industrial process emissions, sinks and energy efficiency? And is the potential offset a sink or emission abatement?***

Renewable energy can provide significant potential offsets within the sector. Non-covered sector abatement potential can also be considered by flexible and appropriate offset arrangements. Care needs to be taken that perverse incentives are not promoted where credits are earned by sectors that are gross emitters. In this case, the sectors should be incorporated into the overall scheme.

***How can Governments ensure that offsets provide abatement above business as usual (ie. that they meet the ‘additionality’ test included in the Kyoto Protocol)***

Activities eligible for offsets must demonstrate physical reduction or avoidance of emissions. Whilst ensuring this outcome is satisfied, the NETS should avoid following directly the complex and often uncertain additionality tests developed under the Kyoto Protocol and applied to the Clean Development Mechanism (CDM). These project-based mechanisms do provide a sound basis to incentivise abatement activity and renewable energy technology deployment.

***Should industrial, commercial or residential energy efficiency offsets be included? What are the benefits and risks of such an approach and how could double counting of emission reductions be avoided?***

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Industrial, commercial or residential energy efficiency offsets should be included. This will result in further reduction in emissions but could result in a very complicated Scheme to administer.

***What adjustments – if any – should be made to the scheme cap to account for offsets to ensure that the economy wide abatement task is achieved and that there is no double counting?***

The cap needs to be set in order to achieve abatement and encourage new investment in offsets.

Appropriate adjustments should be made to the emissions cap only to preserve the integrity of the aggregate abatement task.

Upward adjustments of the overall cap create risks and uncertainty through devaluing the abatement taken to date - therefore undermining the integrity of the scheme.

**Proposition 9**

**That mechanisms be included to address adverse effects and structural adjustment**

***Which trade-exposed sectors are likely to be at a competitive disadvantage as a result of an emissions trading scheme if they are unable to pass through additional costs? How can companies demonstrate the impact of emissions trading on their activities? Should transitional assistance be limited to those that can demonstrate a significant adverse impact?***

It is recognised that the introduction of a NETS has the potential to adversely affect the competitiveness of companies in some trade exposed sectors (for example Aluminium) vis-à-vis companies which operate from countries which are not required to meet emission reduction targets. The resulting loss of competitiveness could, under some circumstances, lead to curtailment of industry expansion and or industry closure.

The Scheme should have explicit provisions for mitigating the impacts on such companies. These should cover:

- The process by which companies demonstrate the impacts of emissions trading on their competitiveness; and
- Mechanisms to mitigate those impacts.

There should be explicit mechanisms to offset impacts on Tasmania which already has very low emission intensity yet could face economic and social impacts.

***What transitional mechanisms could be considered to assist trade exposed sectors until there is a global regime in place, yet still provide an incentive to improve performance? (eg. exemptions based on negotiated agreements along***

***the lines of the New Zealand approach, rebates, free allocation of permits?). At what point should such transitional assistance be removed?***

***What mechanisms could provide appropriate adjustment assistance to affected sectors? Should adjustment assistance be limited to those that can demonstrate impact?***

Mitigation support should only be offered to those companies that are able to demonstrate that emissions trading would result in significant economic loss as a consequence of international trade exposure. The ‘competitiveness at risk’ tests developed and applied in New Zealand provide a good foundation that could be built on.

Mitigation support should be implemented through time bound exemptions from direct and indirect liabilities arising from the Scheme in the form of negotiated greenhouse agreements (NGAs), whereby companies commit to an emissions reduction programme in exchange for:

- Exemption from direct liabilities; and
- Inclusion in the permit allocation process to mitigate indirect liabilities (in particular the increase in electricity prices).

Mitigation support should be subject to periodic review.

An alternative approach would be to provide adjustment assistance to affected sectors through non-tradeable allocations of permits.

### **Proposition 10**

**That mechanisms be included to allow a transition for participants who have taken early abatement action and new entrants**

***Should early movers be protected from disadvantage and how could this practically be achieved?***

Early movers can be accommodated through credit for early action provisions – implemented by including associated emissions reductions in the permit allocation process.

Measures should only apply to direct emissions reduction.

***What criteria should be used to define an ‘early mover’? What period of time should be considered in defining an early mover?***

***Should the definition of an early mover also apply to an organisation that has implemented energy efficiency measures prior to the commencement of the scheme?***

Credit for early action should be offered to the relevant parties from the date on which implementation of the Scheme is first announced.

Eligibility should be contingent on demonstration of real and verifiable emissions reductions associated with liable activities. A mechanism needs to be defined that can take account of any action taken subsequent to the clear signal afforded by the Prime Minister in 1997 announcing '*Safeguarding the future: Australia's response to Climate Change*'

***Should new entrants have access to the same permit allocation as existing parties? If there are different rules for existing and new entrants, when and how should the differentiation be made?***

***Should expansion of existing entities be subject to the same rules as new entrants?***

New entrants to the market should not have access to permit allocation. There have been consistent clear signals from Governments that Australia will be introducing a carbon price signal particularly with the Prime Minister's announcement that Australia intended to meet its Kyoto Target. Thus new entrants should be defined with this clear signal in mind.

The Scheme should ensure that new entrants with greenhouse efficient technologies are not disadvantaged. This could be achieved through equal treatment for all participants (incumbents and new) during the second and any subsequent permit allocations.

## **Other Schemes**

***Should a national scheme replace some or all of the existing schemes or co-exist with them?***

### **MRET and Queensland 13% Gas Scheme**

The Commonwealth Mandatory Renewable Energy Target has been established to support development of the renewable energy sector. Its continuation is critical to the ongoing development of the sector.

There is no design impediment to the co-existence of the MRET nor the Queensland 13% Gas Scheme side by side with a NETS. Such schemes have continued in many European countries regardless of implementation of the EU ETS.

### **The NSW Greenhouse Benchmarks Scheme**

The NSW Greenhouse Benchmarks Scheme is incompatible with a cap and trade scheme, and should therefore be terminated on commencement of a NETS.

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Displacing the NSW Scheme with a NETS is consistent with principles outlined by the NSW Government when it introduced the Scheme.

There should be provisions to incorporate NSW Greenhouse Abatement Certificates (NGACs) subject to consistency with offset criteria (proposition 8). Such projects should be re-accredited under the Scheme and receive offsets as with any other eligible project under the Scheme rules. In particular, generators that have invested in real and measurable abatement under the NSW Scheme should not be disadvantaged.

***Should certificates be fully fungible (or tradable) between schemes?***

In principle, it is desirable to promote fungibility universally between national and international schemes. Currently there is no requirement for fungibility under the model proposed.

**Additional Criteria**

The following additional criteria should be considered:

- Consistency with existing financial market and corporate regulatory structures, management approaches and instrument designs.
- Promoting the development of carbon trading as a mainstream part of the financial industry.
- The implications of spot market design for the associated forward/derivative markets.

Additionally, where the NETS design is based on concepts and mechanisms with no market precedents, there should be provision for time bound experimental testing of such concepts and mechanisms prior to their introduction.

Finally, the NETS should aim as far as possible for regulatory light-handedness, drawing on other national regulatory models in existence.