Energy Supply Association of Australia
www.esaa.com.au

ABN 98 052 416 083

Level 2
451 Little Bourke St
Melbourne

GPO Box 1823
Melbourne
Victoria 3001

P +61 3 **9670 0188**
F +61 3 **9670 1069**
E info@esaa.com.au

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Emissions Trading Working Group Secretariat
The Cabinet Office
GPO Box 5341
Sydney NSW 2001

Possible Design for a National Greenhouse Gas Emissions Trading Scheme

The Energy Supply Association of Australia (esaa) appreciates the opportunity to provide comment on the emissions trading scheme Discussion Paper prepared by the National Emissions Trading Taskforce.

esaa is the peak industry body for the stationary energy sector in Australia. It represents the policy positions of the Chief Executives of 44 electricity and downstream gas businesses in Australia. Our members own and operate some $110 billion in assets, employ over 40,000 people and contribute over $12.4 billion to Australia's GDP.

Over the past three years the Association has given considerable attention to greenhouse gas emissions and energy production. In consultation with member Chief Executives, the esaa has prepared a clear greenhouse policy framework. A central component of this is that the Commonwealth, State and Territory governments should work together to achieve a **single,** national approach to greenhouse gas abatement. The Association notes that, since the release of the Discussion Paper, the Commonwealth Government has announced a Prime Ministerial Task Group on Emissions Trading. This Group is due to report in May 2007 and it would be beneficial for the States and Territories to consider its findings before proceeding with a state-based emissions trading scheme.

A single, national, technologically neutral approach to greenhouse gas abatement – that involves the Commonwealth Government – is more likely to achieve least-cost emissions abatement. An economy wide emissions target is more likely to be secured – reducing the risk of carbon leakage – and only the Commonwealth Government has the authority to represent Australia in international negotiations and commit Australia to international policies and measures that could offer least-cost abatement opportunities. Without the involvement of the Commonwealth Government there is a significant risk to industry participants that an international abatement target will be negotiated that is in conflict with a domestic state-based scheme and this level of regulatory risk would have a negative impact on investor confidence. Electricity consumption is forecast to grow by 65% in 2030 with installed capacity to

increase by over 30,000MW at a capital cost of at least $35 billion to meet this level of demand.

The Association notes with interest the following references to domestic greenhouse gas emissions abatement policy in the recent Energy Reform Implementation Group (ERIG) Discussion Papers:

> *ERIG has been struck by the significant concerns raised by market participants about market uncertainty in relation to possible future greenhouse gas abatement initiatives. Market participants have indicated to ERIG that greenhouse risk constitutes one of the most important barriers to investment in the energy industry, particularly to new base load coal investments. ERIG notes that most market participants desire a coordinated and sustainable policy approach to greenhouse.*
>
> and
>
> *ERIG also notes the current relatively uncoordinated proliferation of state-based renewable and greenhouse schemes. Market participants have noted that these schemes raise regulatory risks, impose additional costs and red tape on energy investors and lead to uncoordinated and inefficient outcomes…*[1].

Given the Association's agreed policy for a single, national, technologically neutral approach to greenhouse gas abatement, with a target set by the Commonwealth Government, esaa cannot support the emissions trading scheme proposed by the National Emissions Trading Taskforce.

However, the Association recognises that State and Territory governments may still choose to pursue a sub-optimal scheme that does not include the Commonwealth Government. In order to provide input into the scheme design, the Association has considered a set of principles, taking the ten design propositions agreed to by first Ministers as given, that would make the scheme design as equitable, effective and efficient as possible.

In responding to the Discussion Paper, the Association has set out some agreed principles, along with their rationale, under a series of headings that group together the relevant fields of discussion.

[1] Energy Reform Implementation Group Discussion Papers November 2006 available at: http://www.erig.gov.au/assets/documents/erig/ERIG%5FDiscussion%5FPapers20061117171022%2Epdf

Scheme coverage and international linkages

National consistency is critical and, if the emissions trading scheme is to be state based, it would not operate effectively without the involvement of all States and Territories.

Rationale

The involvement of all States and Territories in an emissions trading scheme is critical as without this level of participation in a domestic scheme there is a real risk that 'carbon leakage' could ensue with distortions in investment.

Carbon leakage occurs when a greenhouse gas emitting entity shifts from a carbon constrained jurisdiction to a jurisdiction that does not impose the same restrictions on emissions. Carbon leakage results in an erosion of the effectiveness of any scheme to reduce emissions at least-cost, diminishing environmental integrity and it can also provide the migrating entity with a competitive advantage as the onus on them to reduce their emissions, and hence the financial impost of doing so, is removed. For example, if Western Australia or Queensland were to opt out of a state-based emissions trading scheme then investments in energy intensive industries, like aluminium, could be expected to shift to those locations where there is not a cost on greenhouse gas emissions.

The detrimental impacts of 'carbon leakage' are a common theme when global measures to achieve greenhouse gas emissions reductions are debated.

In addition, in a National Electricity Market, the participation of all jurisdictions is critical to ensure there is minimal distortion to both the market mechanism and investment.

Provided Australia is not disadvantaged by its participation, an Australian emissions trading scheme should be linked to international schemes in order to facilitate access to lower cost abatement opportunities including emissions offsets.

Rationale

Significant benefits could be derived from Australia linking to international schemes that are aimed at reducing greenhouse gas emissions. The primary benefit of pursuing international linkage is a lowering of Australia's net cost of emissions abatement. For example, Australia may be able to benefit from low cost abatement activities undertaken in developing countries under the Kyoto Protocol Clean Development Mechanism.

The precursor that international linkage should only occur 'provided Australia is not disadvantaged by its participation' is to ensure that linkage does not lead to a situation in which a domestic permit shortfall arises, as a result of Australia having a lower emissions abatement cost than international schemes, which in turn could diminish domestic permit supply. The flow on effect of this scenario is an increased cost of emissions abatement domestically and the possibility that some domestic emitters are unable to source sufficient permits to meet their needs.

A further caveat to Australia linking to any international greenhouse gas emission abatement scheme and securing any emission reduction credits from these schemes is that it is critical that international schemes are supported by a 'robust, transparent and credible monitoring and verification system'[2]. Without this approach, there is a risk that the credibility of the domestic scheme could be eroded if permits do not represent an equivalent amount of greenhouse gas emissions reduction.

All greenhouse gas emitting sectors, sources and sinks should face the cost of releasing greenhouse gas emissions into the atmosphere. However, initially it may be difficult to apply an emissions trading scheme across all sectors, sources and sinks. For example, the transaction costs of incorporating agriculture and transport sector emissions at scheme commencement may be considered too large. Therefore, alternative policies and measures may initially be required to ensure that these sectors face an equivalent cost for their emissions with a focus on integrating these sectors into an emissions trading scheme once the best means for their inclusion is determined.

Rationale

If a charge for releasing greenhouse gas emissions into the atmosphere is to be introduced then this cost should not be applied to emissions in some sectors and not others. Limiting the coverage of any scheme to address emissions will distort investment decisions, reducing allocative efficiency, and lead to an inequitable outcome whereby the burden of achieving emissions reductions will not be shared by all greenhouse gas emitters.

The possibility of expanding scheme coverage post commencement, as raised in the Discussion Paper, also raises concerns. This approach could create permit price fluctuations, particularly if there are significantly lower/higher cost emissions abatement opportunities available in those sectors entering the scheme (assuming the lower cost opportunities had not been captured through the use of offsets). This outcome would have flow on effects and detrimentally impact investor confidence and scheme credibility. Ensuring that scheme coverage is as broad as possible at scheme commencement would reduce the possibility of this outcome arising.

The Australian Greenhouse Office noted the importance of scheme coverage in its National Emissions Trading Discussion Paper 4 stating that 'comprehensive emissions coverage is important because it allows the system to drive abatement incentives into all parts of the economy, thereby maximising the chances of capturing abatement opportunities that are least-cost'[3].

However, it is important that the benefits of achieving greater scheme coverage are weighed up against the transaction costs of its achievement. For instance, diffuse emissions from the transport and agriculture sectors may be difficult to measure, estimate, and hence, capture under an emissions trading regime. In these instances it may be more appropriate to initially apply a different policy measure – such as a carbon tax on emissions from these sectors – to ensure that they also face the cost of releasing greenhouse gas emissions. To date, very little work has been done on developing a broad policy framework (potentially with a variety of measures) that

[2] Australian Greenhouse Office Emissions Trading discussion paper 4 - http://www.greenhouse.gov.au/emissionstrading/papers/paper4/pubs/paper_4.pdf
[3] http://www.greenhouse.gov.au/emissionstrading/papers/paper4/pubs/paper_4.pdf

covers all emissions and the States and Territories would benefit from undertaking this work rather than focusing on one measure to cover one sector.

For example, it is feasible that a greenhouse gas emissions tax could be set at the same rate as the emissions trading scheme penalty, which the Association considers should be set at a level just above the marginal cost of abatement. Setting the tax at the emissions trading scheme penalty would ensure consistency between measures as to the maximum cost of emissions abatement and encourage sectors paying the emissions tax to join the emissions trading scheme in order to reduce their costs of compliance.

The Discussion Paper seeks comment on an example where the introduction of an emissions trading scheme may distort marginal transport costs in favour of diesel powered locomotives in Queensland in lieu of electric-powered locomotives. In line with the Association's approach this issue could be effectively addressed, until such time as transportation emissions are covered by an emissions trading scheme, by taxing diesel fuels to ensure that their use also incurs a cost equivalent to that which would be borne/incurred by electric-powered locomotives. This approach removes the incentive to shift from electric to diesel powered locomotives and the possibility of adverse economic efficiency impacts is removed as investment decisions would no longer be distorted and consumers would also face the full cost, including the environmental costs, of their consumption.

Stationary energy sector emissions should cover emissions from the combustion of energy in the following areas: energy industries; manufacturing industries and other sectors i.e. energy use by commercial, institutional and residential sectors (as per the definition used by the National Greenhouse Gas Inventory (NGGI)).

Rationale

The NGGI is based on international guidelines established by the Intergovernmental Panel on Climate Change (IPCC). Accordingly, this principle ensures that the emissions trading scheme is compatible and consistent with existing domestic greenhouse gas emissions accounting practices and therefore that the coverage of stationary energy sector emissions is comprehensive.

Using the NGGI definition for the stationary energy sector will also provide parties with greater confidence as to the emission accounting practices supporting the scheme.

The most effective and efficient point to place emission liabilities for electricity generators is at the point of emission i.e. at the power station. An effective and efficient point for emissions from natural gas is more difficult to identify and any methodology should be clear to avoid double counting.

Rationale

Placing the liability for electricity greenhouse gas emissions at their source will facilitate: the identification of the facilities to be covered; effective scheme administration and compliance: as well as the efficient pass through of costs associated with scheme implementation. In addition, electricity generators have the greatest ability to influence the level of emissions from the sector.

Natural gas emissions are somewhat more difficult. If the emission liability is placed upstream, then fugitive emissions from pipelines need to be considered and natural gas as an input to electricity generation should be exempt. If the emission liability is downstream, then a mechanism for including small domestic gas users needs to be developed.

The threshold level for scheme participation for electricity generators (30MWe) proposed in the discussion paper seems reasonable. However, there may be some difficulty, as a result of a deficiency in data, in extending the scheme to facilities that emit 25,000 tCO2-e a year. It may therefore be more effective to initially target sources above the proposed 25,000 tCO2-e level and gradually decrease the level of coverage over time as scheme knowledge and experience improves.

Rationale

The Association's fundamental position on scheme coverage is that it should be as broad and comprehensive as possible to improve the possibility that the implementation of such a scheme will achieve an efficient outcome and reduce emissions at least-cost. This approach is also more equitable as the burden, and costs, of emissions reductions is shared by all emitters. However, pursuing the inclusion of facilities that emit 25,000 tCO2-e at scheme commencement may be difficult if there is insufficient data to ensure complete coverage at this level of emissions.

esaa members have indicated that there may be some difficulty in identifying emission point sources at the level indicated in the Discussion Paper of 25,000 tCO2-e. The Association is therefore proposing that, at least initially, the targeted level of coverage may need to be set at a higher level, and lowered over time, to account for the fact that current data insufficiencies may result in inadequate coverage at this level. This approach will ensure that the transaction costs associated with securing coverage of facilitates at the level identified in the Discussion Paper does not erode the benefits of scheme implementation.

Scheme cap

Under an economy wide emissions target emission caps should be set at a level proportionate to each sector's share of emissions.

Rationale

The focus of this principle is to equitably distribute the burden of achieving reductions in emissions amongst emitting sectors and to ensure that any opportunities to reduce emissions in other sectors, at lower cost, are also secured.

Mutual exposure to the cost of releasing greenhouse gas emissions will drive collective economic behaviour and is more likely, if market mechanisms are used to allocate property rights, to result in an economically efficient outcome. The importance of the allocation of property rights and achieving economic efficiency is the central tenet of the Coase Theorem which dictates that in the event of market failure, as long as agents are ascribed property rights, then they will negotiate the most efficient outcome. Inequitably sharing the burden of achieving emissions

abatement amongst emitters would therefore distort market outcomes and reduce the possibility of emissions abatement being achieved efficiently and at least-cost.

If State and Territory governments want to implement emissions trading ahead of an international agreement and without the involvement of the Australian Government, they must be prepared to accept financial responsibility for the risks this entails for energy companies.

Rationale

The lack of an internationally agreed greenhouse gas emissions response increases the risks to domestic energy companies of responding to a domestic emissions trading scheme. This is due to the fact that a domestic scheme could realistically be superseded by an international agreement to reduce emissions.

Further, without the involvement of the Commonwealth Government from the outset, there is a real risk that it could, at some point in time in the future, decide that it wishes to implement an alternative approach to reducing emissions domestically. For example, the Commonwealth Government could determine that the taxation of greenhouse gas emissions is a more effective mechanism by which to achieve a reduction in emissions than an emissions trading scheme.

There is also a real possibility that the Commonwealth Government could determine that an alternative emissions abatement target, than that identified in the Discussion Paper, is required. If this outcome arose it would also significantly affect domestic emissions abatement activity, creating uncertainty and destabilising permit prices and hence committed investments. Investors cannot be expected to make investment decisions on the basis of policy settings that could change substantially in the future and affect the value of their assets.

The principle that States and Territories must accept financial responsibility for pursuing an emissions trading regime without an international agreement and the involvement of the Commonwealth Government seeks to cover the financial risk and exposure energy companies could face should the proposed scheme be superseded by an alternative domestic, or international, response.

A firm cap followed by gateway targets seems a reasonable proposition provided the scheme regulator takes responsibility for any variation in the target over the life of the scheme by buying and selling permits and governments provide compensation to market participants should they suffer economic loss as a result of any variation in the scheme target.

Rationale

Given the difficulty of effectively determining the quantum of an emissions abatement target 20 years hence the approach proposed by the Discussion Paper to set the target for a ten year fixed period and then provide a ten year gateway seems reasonable.

The approach outlined in the Discussion Paper is an option designed to provide increased confidence to parties going forward and at the same time also provide increased flexibility to adjust the scheme cap in light of new evidence or understanding of climate change and its impacts. However, with this flexibility

governments must also bear the responsibility to buy and sell permits to address any variation in the scheme cap. Governments would also be responsible for providing sufficient redress to scheme participants should target variations result in their suffering economic losses.

Nature of permits, allocation and compensation

Noting that the free allocation of permits is a compensatory mechanism to address economic loss of value, the allocation of permits in an emissions trading scheme should be based on a mix of both free allocation and auctioning. Once greenhouse gas emitting generators have been adequately compensated any subsequent allocation of permits should be auctioned.

Rationale

The free allocation of permits to existing greenhouse gas emitting generators (including committed projects) - that is sufficient to compensate them for the change in the net present value of their asset arising from the implementation of an emissions trading scheme - recognises that these entities will face a different economic future following the implementation of a scheme that places a cost on greenhouse gas emissions.

The specifics of this approach would involve an initial free allocation of permits to existing greenhouse gas emitters with any remaining permits to be auctioned once existing greenhouse gas emitting electricity generators have been adequately compensated for the change in the net present value of their asset.

The Association considers that only existing greenhouse gas emitters, whether in the stationary energy, transportation or agriculture sectors, should be provided a free allocation of permits. This argument is based on the premise that any future greenhouse gas emitting entity will have the benefit of exposure to the operation of the emissions trading scheme which will therefore place them in a position to effectively determine the risks associated with any capital (both financial and physical) investment.

Furthermore, in relation to the stationary energy sector, new entrants will be able to choose to invest in lower emission technologies for which they will receive a financial reward as a result of the change in the electricity price arising from the introduction of the scheme.

Therefore the key distinction, between existing and new electricity generators, is that existing generators have no choice with regards to their capital utilisation strategy whereas a prospective new entrant is able to assess the risks, costs and benefits of entering into a market in which a cost has been imposed on the release of greenhouse gas emissions. However, it is important to note that the uptake of new low emission technologies, under this approach, will be dependent on the rate of change in the wholesale energy price in response to the implementation of an emissions trading scheme. If the rate of change is slow, low emission technologies may require some form of assistance, either through direct subsidisation or through a free allocation of permits, to facilitate their entry into the market.

The proposal that any subsequent allocation of permits should be auctioned is an extension of the argument that new entrant generators should not receive a free

allocation of permits. Once an emissions trading scheme is up and running and existing generators have been adequately compensated, through receipt of a free allocation of permits, the most effective mechanism by which any future permit allocation could be administered is via auction. This is due to the fact that market participants will be exposed to the value of permits and their own permit needs. This approach also removes the risk to the market of any further free allocations of permits eroding market value or creating fluctuations in permit values.

The free allocation of permits to existing greenhouse gas emitting electricity generators should reflect the economic life of the asset. This could be achieved by allocating permits equal to the change in the net present value of the asset.

Rationale

The free allocation of permits is a compensatory mechanism to address economic loss of value. The calculation of the level of compensation necessary to address the loss of value could be achieved by determining the change in the net present value of the asset, over its economic life, arising from the implementation of an emissions trading scheme.

This approach would require an assessment of a number of input values such as the future value of permits and the targeted emission level but would ensure that the asset is adequately compensated following the implementation of an emissions trading regime.

In order that voluntary, early (prior to scheme commencement), action to reduce emissions is not disadvantaged, the permit allocation methodology must consider the impact of this voluntary action when assessing any change in the net present value of the asset resulting from the introduction of an emissions trading scheme.

Rationale

It is important that voluntary emissions abatement action is not disadvantaged prior to the commencement of an emissions trading scheme or because such a scheme is pending. Delayed abatement action can arise as a result of an agent's desire to ensure that their investment to reduce emissions is adequately recognised.

By recognising early, prior to scheme commencement, abatement action the distortions and resulting inefficiencies which may be caused by delaying action would be removed. Adequately recognising early abatement action therefore provides agents with certainty that their investment will be rewarded, economic efficiency is also improved (analysis has shown that early action to abate emissions costs less than delayed action) and there are also environmental benefits as the total quantity of emissions released also decreases.

The Association considers that voluntary emissions abatement action that occurs prior to scheme commencement should be recognised by the scheme administrator. This is a complex task and would involve assessing the impact on the net present value of the asset both with and without early action and providing the agent with an allocation of permits that are equivalent to any decrease in the net present value of the asset resulting from the early action and the introduction of the scheme. The

incorporation of this proposal recognises that abatement action involves a financial cost and will ensure that voluntary emissions abatement activity is not disadvantaged as a result of concerns regarding financial disadvantage associated with the timing of such action.

Both existing entities that emit greenhouse gas emissions as well as new entrants should be able to purchase permits.

Rationale

The proposition that both existing and new entrant greenhouse gas emitting entities be able to purchase permits ensures that the implementation of an emissions trading scheme does not restrict the actions of existing emitters or create a 'barrier to entry' to new entrants. Further, this approach increases the probability of a healthy permit market developing as it increases the potential number of permit traders and hence improves market liquidity.

Market liquidity is an important indicator of a well functioning market and is determined by the number of buyers and sellers in the market and the volume of market trade. Illiquid markets are likely to be less efficient as market participants can interfere with the free operation of the market through exercising market power. This in turn can detrimentally affect market entry and exit, price stability and confidence among market participants[4].

The competitiveness of existing and new trade-exposed energy-intensive industries should be protected by utilising a border tax adjustment in lieu of their receiving a free allocation of permits.

Rationale

The Association acknowledges that without some form of policy or measure to protect trade exposed energy-intensive entities from the cost increases associated with the implementation of an emissions trading scheme they are likely to incur significant economic losses. However, the Association considers that providing both existing and new trade exposed energy-intensive industries with a free allocation of permits is not the most effective, or efficient, mechanism by which to achieve this objective.

Under the Discussion Paper proposal each new entrant is provided a free allocation of permits. This approach is likely to distort market outcomes and create permit price fluctuations as a result of the fact that the quantity of available permits under the proposed emissions trading scheme is limited. Therefore any large allocation of permits to new entrant trade exposed industries is likely to have an impact on market equilibrium and drive prices up.

Accordingly, the Association considers that a more effective instrument by which to compensate energy-intensive trade exposed industries is through a border tax adjustment. This would involve a tax adjustment at the border to reflect the level of additional costs incurred as a result of the fact that energy costs have increased. This approach would remove the possibility of a free allocation of permits to trade exposed energy-intensive industries distorting permit market outcomes.

[4] http://www.greenhouse.gov.au/emissionstrading/papers/paper4/pubs/paper_4.pdf

The Association notes that the Discussion Paper also raises the possibility of utilising border tax adjustments to protect trade exposed energy-intensive industries but that this would require the involvement of the Commonwealth Government. The Association considers that this issue adds weight to its argument that States and Territories should work together with the Commonwealth to achieve a single national approach to greenhouse gas abatement as it opens up the possibility of alternative measures being utilised, such as border tax adjustments, to ensure that the greenhouse response is as efficient and effective as possible.

Revenues generated from permit auctioning and penalty payments over the life of the scheme should be invested in emission abatement activities including research and development into low emission technologies.

Rationale

The auctioning of permits, and the payment of any penalties by scheme participants, in an emissions trading scheme provides the scheme administrator with a source of revenue.

In order to ensure the environmental integrity of the scheme it is important that any revenues generated from such sources are directed towards emissions abatement activities including the funding of research and development activities into low emission technologies. Aside from the environmental integrity of this approach a further benefit is that it may also contribute to a lowering of emission abatement costs.

This proposition also recognises the possibility that revenues derived from permit auctioning and the payment of penalties could become a source of general revenue for governments. This outcome would be problematic as it could mean that the environmental integrity of the scheme is diminished (as penalties would not be applied to emissions abatement). While governments may wish to use the funds to shield energy users from the price rises associated with applying a cost to greenhouse gas emissions, this would be counter-productive as a clear price signal to consumers is important to avoid over-consumption. To assist the environmental objectives of the scheme, governments would be better to invest in assisting end users to improve their energy efficiency.

Scheme Penalty

Recognising that the marginal cost of abatement should be calculable - given that such calculations have been completed for the Mandatory Renewable Energy Target and the NSW/ACT Greenhouse Gas Abatement Scheme - the scheme penalty should be set just above the marginal cost of abatement, contain an indexation component, and be sufficiently stable to generate confidence for market participants.

Rationale

In an emissions trading scheme the scheme penalty can have a dual role in that it can encourage entities to comply with the scheme but can also be used to cap the cost of scheme compliance by underpinning a value for emissions.

Encouraging scheme compliance through the imposition of a non compliance penalty is critical if the scheme is to achieve its objectives, remain credible and emission permits are to retain their value. In order to achieve this objective the scheme penalty must be set at a level that is above the marginal cost of abatement otherwise affected parties would be indifferent to paying the penalty which would have a detrimental impact on the environmental integrity of the scheme.

Without a penalty for non compliance permit values would rapidly decline as the ramifications for failing to surrender sufficient permits to cover emissions would significantly diminish and the environmental integrity of the scheme would also be detrimentally affected.

Underpinning a value for emissions by setting the scheme penalty at a level just above the marginal cost of abatement provides market participants with a firm understanding of their exposure to the market and successfully allows participants to more effectively manage the transition to an emissions trading regime.

An emissions trading scheme penalty could be set at a level much higher than just above the marginal cost of abatement. For instance, the EU Emissions Trading System scheme penalty is €40 per tonne of CO2 for Phase I (2005–07) rising to €100 per tonne of CO2 for Phase II (2008–12). Currently the EU permit price is at approximately €10 per tonne of CO2. Accordingly, it is possible to argue that the EU scheme is more focussed on ensuring scheme compliance than with managing transition.

However, the Association considers that setting a scheme penalty at a level much greater than just above the marginal cost of abatement, as in the EU scheme, increases the possibility of an unnecessary cost being injected into the industry, and the wider economy, without achieving greenhouse gas emissions abatement.

The Association therefore considers that setting the scheme penalty at a level just above the marginal cost of abatement, including an indexation component to allow the penalty to increase over time, would create sufficient incentive to entities to comply with the scheme, ensuring environmental integrity, whilst also reducing the possibility of unmanageable economic impacts arising from scheme implementation.

An emissions trading scheme should not contain a make good provision.

Rationale

A make good provision, whereby scheme participants need to purchase permits to make up any permit shortfall in addition to paying the scheme penalty, is unnecessary as long as the revenues that are generated from the payment of the scheme penalty are utilised for emissions abatement. If this occurs then there should be no need for a make good provision as the environmental integrity of the scheme is secure.

Further, as recognised in the Discussion Paper, the inclusion of a make good provision in an emissions trading scheme uncaps the costs of scheme compliance, reduces certainty for investors and increases the risk of large economic impacts arising from affected parties seeking to secure sufficient permits to comply with the provision.

Banking and borrowing

Permit banking within allocation periods should be unrestricted in order to enable entities to take advantage of least-cost abatement opportunities throughout the period. However, it is important that there is sufficient transparency as to the volume of banking taking place.

Rationale

The capacity to bank surplus permits provides entities with an effective mechanism to minimise their costs of scheme compliance. For example, an entity may be in a position to secure and bank a quantity of permits at a low price at scheme commencement (effectively securing 'low hanging fruit') which may then be utilised to comply with scheme requirements at a later period when permit prices are much higher and lower cost opportunities have been exhausted. Unrestricted banking therefore allows participants to smooth scheme compliance costs and effectively hedge against the real possibility of future permit price increases.

Borrowing should not be allowed as the market can provide the necessary credits if market participants experience a permit shortfall. However, tolerance is necessary and there should be a degree of flexibility with regards to parties' compliance with targets with the possibility of being 'over' or 'under' from period to period.

Rationale

This principle recognises the risks associated with the borrowing of permits. The capacity for scheme participants to borrow emissions permits from future periods to meet their obligations has significant ramifications as it delays progress in achieving emissions reductions. Furthermore, there is a real risk, as a result of the borrower having had to borrow once to achieve compliance, that the entity may need to borrow again and that it may also not be able to repay the borrowed allowances. Allowing permit borrowing could therefore reduce scheme credibility, participant's confidence and erode the effectiveness of the scheme to achieve a targeted level of emissions abatement.

The proposal to incorporate an **'**overs' and 'unders' component in complying with the scheme requirements recognises that exactly meeting a target each year does not adequately reflect the unforeseen fluctuations in operation that an entity may experience over the course of a year.

Conclusion

Securing greenhouse gas emission reductions in an efficient manner requires a robust, transparent and rational regulatory framework.

As the Association has identified a single, national emissions abatement response developed with the Commonwealth, State and Territory governments is the most efficient and effective approach. Not pursuing this approach is likely to be suboptimal, as the economic cost of achieving greenhouse gas emissions reductions is likely to be higher and lead to a less efficient utilisation of scarce resources. In addition, the fractured approach to greenhouse gas abatement between the Commonwealth and the States and Territories creates a significant regulatory risk. This could significantly

erode efficiencies gained from over a decade of energy sector reform and may also stifle future energy sector investment at a time when significant investment will be required to ensure that demand is efficiently, and effectively, met.

The Association considers that the principles outlined above provide some guidance in response to a suboptimal scheme design.

Yours sincerely

Brad Page
Chief Executive Officer