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Mr Roger Wilkins
Chair
Inter-jurisdictional Emissions Trading Working Group
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Dear Mr Wilkins

BACKGROUND PAPER: A NATIONAL EMISSIONS TRADING SCHEME

NRG offers the following comments on the background paper released by the Inter-jurisdictional Working Group on Emissions Trading for consultation on 12 September 2005.

By way of background, NRG is an integrated energy business centred around base load electricity generation, energy trading and retail operations, with assets in South Australia and Queensland. The South Australian portfolio comprises approximately 940MW of generation, encompassing the base load coal-fired Northern and Playford Power Stations at Port Augusta, the Leigh Creek coal mine and rail line, and the output of the gas-fired Osborne Power Station (under power purchase agreement). These assets were acquired following the disaggregation of the South Australian electricity industry in 1998 by the US-based global energy company NRG Energy, Inc in 2000. The Queensland assets comprise a 37.5% interest in the 1280MW coal-fired Gladstone Power Station, which is also operated by NRG.

Introduction

In order to make an effective and meaningful contribution to global greenhouse abatement, an emissions trading scheme must satisfy a number of conditions.

Firstly, an emissions trading scheme must be linked to targets which move in step with

global abatement efforts. Given that Australia as a whole accounts for little more than one percent of world greenhouse emissions, there would appear to be little that the nation can do in isolation to arrest global emissions in the absence of coordinated international action. In fact, unilateral action could be counter-productive if taken independently of global efforts, and be both ineffective in terms of meaningful global abatement and damaging for the national economy.

Secondly, an emissions trading scheme must be integrated within a broader policy framework embracing all emission sectors, sources and sinks, supported by all levels of Government. A narrowly focused scheme applying only to certain sectors in the absence of a broad based policy platform addressing all contributions to emission reduction risks imposing serious distortions, inefficiencies and cost burdens, without achieving material and lasting benefits.

Thirdly, an emissions trading scheme needs to be supported at federal level. Only the Commonwealth Government can influence Australia's international commitments and obligations towards emission reduction, which will necessarily drive the targets and framework underpinning any emissions trading scheme. To proceed without such support only creates untenable sovereign risk for all participants, and threatens future investment.

NRG believes that these conditions have yet to be satisfied:

- At this stage, Australia's future international abatement obligations are unclear, and there is a lack of broad international commitment to agreed targets. The prospects of a sustainable international emissions trading scheme emerging are also uncertain. The imperative and basis for an Australian emission trading scheme at this point in time is therefore unclear.
- There appears to be no overarching greenhouse policy framework embracing all emission sectors, sources and sinks into which an emissions trading scheme would be integrated. It is impossible to meaningfully assess the role of an emissions trading scheme in the absence of such a framework.
- There is no support for such a scheme from the Commonwealth, and by the Working Group's own admission, nothing to prevent the Commonwealth from constitutionally overriding a State based scheme.

Progress therefore needs to be made on all three fronts before an effective emissions trading model could be developed for implementation.

Mindful of these threshold issues, NRG offers the following by way of initial comment on the ten proposed design elements of an emissions trading scheme put forward by the Working Group.

1. Cap and trade approach

A cap and trade model appears to have a number of strengths over available alternatives. However, as the design features of the scheme are closely interrelated, this feature can not be considered in isolation from the issues of permit allocation, sectoral coverage, transition and adjustment. The preferred model will ultimately depend on the approach taken to these issues.

2. National and sectoral basis

A nationally consistent basis for the design of any scheme is highly desirable. However, a truly national scheme by definition must also:

- have the support of the national government, as discussed above;
- be seamless in its application across all States and territories, with no provision for State-specific 'carve outs' or derogations;
- replace all State based schemes.

A sectoral basis for scheme design is justified only if it is intended that the scheme apply broadly across all emission sectors and sources, or if complementary and integrated policy measures are in place to tackle emissions across all other sectors on an equivalent basis as part of a comprehensive and cohesive response. However, neither of these options appear to be under consideration at present. The alternative is a narrow and selective focus on specific sectors in isolation, which is not supported.

3. National target allocated between sectors

Whilst the concept of a national target could be supported, it clearly needs to satisfy the 3 threshold criteria outlined above. In particular, it needs to be linked to national obligations, which should in turn be determined by the pace of global abatement efforts. As Australia is on track to meet its current Kyoto target, and targets beyond this commitment period are as yet unknown, it is unclear that any national target can be meaningfully applied at this point.

If these conditions can be satisfied in the future, any emissions trading scheme should

apply a national target broadly across all emission sectors and sources. This will ensure that the efforts of all sectors are appropriately harnessed in the pursuit of efficient, least cost emission abatement. Failing this, complementary policy measures are needed to tackle emission reduction across all other sectors on an equivalent basis. However, it will be extremely challenging to meet the goal of equalising marginal abatement costs across sectors under this approach, unless compatible market based instruments are applied across all sectors. This again underlines the need for a comprehensive policy response encompassing all relevant sectors.

4. Stationary energy sector

Little justification has been provided for limiting the scope of any emissions trading scheme initially to the stationary energy sector. Aside from administrative convenience, there is no apparent advantage in excluding all other relevant sectors and sources of emissions from a carbon cost signal, and targeting an extremely limited number of emission sources across the nation. To penalise one sector alone does not appear to be the most efficient way to manage emissions to a national target.

A least cost and efficient abatement response must embrace all contributing sources across the economy equally, as outlined above, ideally through a broad based emissions trading regime or similar market based approach that applies a carbon price signal to all sources of emission.

Alternatively, if emissions trading is to be confined to certain sectors, at the very least a comprehensive policy platform addressing all other forms of emissions must be established. Otherwise there is a serious risk that initially targeted sectors will be required to bear a disproportionate share of the burden, resulting in inefficient outcomes and distorted incentives. Industry participants are therefore in no position to support a narrowly targeted emissions trading regime at the present time in the absence of any information on future abatement policy with respect to other sectors.

It must also be remembered that energy itself is a fundamental economic input, demand for which is driven largely by economic growth. The complex interactions and multiplier effects associated with energy costs exacerbate the distortions and burdens created by a narrow focus on one sector alone. As a resource intensive economy dependent on the competitiveness of its energy supplies, Australia appears particularly vulnerable in this respect. This again highlights the importance of a broad based approach, moving in step with global action.

5. Coverage of all 6 greenhouse gases

Broad coverage of all material greenhouse gases is highly desirable. Omitting contributing gases reduces the effectiveness of the scheme and adds to costs. In the same way, it is essential that the scheme be broadly based to cover all relevant emission sectors and sources, to maximise the scope and reach of the scheme. A narrow focus on only one greenhouse gas would limit the effectiveness of the scheme, as would a narrow focus on one sector alone.

6. Permit allocation

It has been proposed that the distribution of emission permits would occur through a mix of administrative allocation methods (with or without cost) and permit auction. It has also been suggested that permits could take the form of both short and long term instruments.

In principle, there is no objection to such an approach, provided there is adequate transition and an appropriate allocation of permits to existing participants.

The existing rights of participants should be fully preserved through permit allocation, at least for the remaining economic life of existing investments. This avoids inefficient wealth transfers that damage existing participants and undermine future investment certainty. The use of long-term instruments for this purpose may maximise certainty, and individual baselines may be most appropriate based on plant design. This approach also recognises that massive investment in new technology will be required to meet meaningful and sustained emission reduction targets in the face of continued energy growth over the long term, and that long asset lives and investment lead times limit the extent to which wholesale change will be achievable in the short term.

The alternative of incomplete or partial grandfathering will only serve to impose a significant cost burden on existing participants with consequent impacts on downstream energy costs, while achieving little in terms of meaningful abatement. With appropriate grandfathering it should therefore be possible to achieve the same ends, without the cost of massive wealth transfer and uncertainty.

The use of any scheme revenue raised through auction for new participants and new supply sources may most usefully be allocated to R&D funding, recognising the level of technological development that will be required over the medium term as above to achieve sustainable and long term emission reduction.

7. Appropriate penalty

A shortfall penalty provides both a means of ensuring compliance with any emissions

trading regime and sets a cap on the maximum cost of emission abatement, as noted by the Working Group.

The establishment of a cap at or about the expected level of marginal abatement cost perhaps provides the most reasonable approach, consistent with the precedent set by many existing schemes. Setting a cap at a higher level only risks imposing an unexpected cost burden. Conversely, the impact of reduced certainty over actual levels of abatement achieved might be seen as limited at this stage given the state of flux over international targets, and the importance of aggregate rather than annual outcomes.

Flexible banking and borrowing provisions are desirable, consistent with the ultimate objective of reducing cumulative emissions. Shortfall allowances also appear to provide for a workable approach. However, a 'make good' provision appears inconsistent with the notion of a shortfall penalty, and also defeats the role of the penalty in providing a cap on abatement cost.

8. Offsets

Maximum scope for offsets appears consistent with the principle of ensuring the broadest possible response to emission abatement. Having said this, the inclusion of offsets is in no way a substitute for a broad based and consistent policy response covering all sectors, sources and sinks. In fact offsets may only create a wealth transfer to certain sectors that lie outside an emissions trading scheme (if narrowly focused) that stand to gain from abatement action, whereas economic efficiency would dictate that all relevant sectors should face the same marginal cost and incentive to abate. Offsets therefore play an efficient role only in a comprehensive policy response embracing all relevant sectors, as outlined above.

9. Adjustment mechanisms

The issue of adjustment mechanisms and assistance highlights the importance of keeping pace with global targets and abatement action. This will limit the need for adjustment assistance for the trade-exposed sectors if our international competitors are facing the same carbon cost signals and pressures.

It should also be remembered that the biggest affected stakeholders will be energy producers. In this respect there is a clear need to link assistance measures with the permit allocation methodology, to ensure that adequate adjustment assistance is provided to

manage transitional impacts.

For efficiency, it is also important that there is full pass through of abatement costs to end users through energy pricing. This will ensure that carbon costs are internalised in all consumption decisions, which will provide greater impetus for demand side measures such as energy efficiency. Any adjustment assistance should be targeted directly at those consumers most in need, and not through general distortion of energy pricing. Limited pass through of carbon costs will only constrain prices below efficient levels, and exacerbate the demand pressures that drive the increasing need for energy in the first place. The supply side and demand side have an equal role to play in any broad based abatement strategy.

10. Transition for early action and new entrants

The permit allocation methodology could be suitably tailored to account for early abatement action undertaken by participants, possibly through some form of historic baseline. This should be linked to the grandfathering of abatement rights to existing participants, and could take the form of an allocation based on the historic design baseline of existing plant, thereby rewarding additional emission reduction achieved through the allocation of additional permits.

The economic grounds for a free entitlement for new entrants must be questioned. Any such entitlement should be allocated on world's best practice basis at least, but preferably provide stronger incentives. Any new entrant reserve should also be tied to the need for market driven investment only. In practice this may be difficult to determine. A new entrant reserve might therefore be considered a transitional measure only.

Summary

The basis and imperative for the introduction of an emissions trading scheme in Australia at the present time must be seriously questioned. Before any such scheme could be meaningfully applied, a number of fundamental threshold criteria must be satisfied. The scheme must move in step with global abatement commitments, it must form a component of an integrated policy platform covering all emission sectors, sources and sinks, and it must be fully supported at federal level. It appears significant progress is required on all these fronts before a meaningful and effective scheme could become a reality.

Only once these conditions are met, will it then be possible to examine in detail the specific elements of such a scheme. For the purposes of initial discussion, comments on a number of specific design features are provided above. Most fundamentally, introduction of a scheme needs to preserve the rights of existing participants so as not to threaten the prospects of the massive investment that will be required in the energy sector to meet the twin challenges of growing energy demands and emission abatement moving forward. Market based emission reduction incentives and complementary measures must also be applied as broadly as possible in order to achieve least cost abatement and harness the full spectrum of sources and solutions to this global problem.

NRG appreciates the opportunity to offer these initial comments to the Working Group. Should you have any immediate queries in relation to this submission, please contact Reza Evans (08 8372 8726) or Simon Appleby (08 8372 8706).

Yours sincerely

Tom Richardson
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