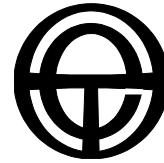


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Submission to:

**INTER-JURISDICTIONAL WORKING GROUP'S
'A NATIONAL EMISSIONS TRADING SCHEME'
Background Paper for Stakeholder Consultation**

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INTRODUCTION

Total Environment Centre congratulates the NSW Government for taking a leadership position in the establishment of multi-state emissions trading scheme (ETS). Emissions trading can help deliver real and timely reductions in greenhouse gas emissions, but only if the scheme is designed appropriately. A poorly designed scheme could impose a cost on consumers for little or no environmental benefit, and could hinder future efforts to reduce GHG emissions by creating a false impression that action is being taken.

Emissions trading should only ever be part of a broader framework of policies that bring about greenhouse gas emissions reductions. The establishment of an ETS should not compromise other complimentary approaches such as incentives for renewable technologies, clean gas and energy efficiency, regulations, targeted subsidies and R&D. Rather, an ETS should be one part of the strategy for meeting a reduction target of at least 60% by 2050.

LEVEL OF CAP

The key issue for a successful trading scheme is the level at which the emissions cap is set. Key principles in determining the emissions caps are:

- Environmental effectiveness: the caps should achieve at least 60% reduction in greenhouse emissions from 1990 levels by 2050. ***If environmental outcomes are not achieved a trading scheme is simply an additional transaction cost with no benefit.***
- Ensuring a smooth transition: intermediate caps are required to ensure a smooth transition and avoid unnecessary shocks to the economy and give investor certainty.
- Reducing cumulative emissions: the intermediate caps are also needed as they determine the total cumulative emissions.
- Driving technological change: the cap should help drive best practice zero to low emission technologies into the energy market, and ensure that existing carbon intensive infrastructure is retired at the end of its economic life.

KEY DESIGN CRITERIA

Environmental effectiveness must be the overriding design criteria. This means that the scheme must have the ability to achieve emissions reductions to avoid global temperature rise of 2°C. This is currently thought to require at least a 60%

reduction in greenhouse emissions from 1990 levels by 2050, but more stringent limits may be required over time.

The key criteria for the scheme are:

- Capacity to achieve emissions reductions;
- Minimises manipulation and reduction of emissions beyond business as usual;
- Flexibility to incorporate more stringent emission levels over time;
- Capacity to facilitate structural adjustment;
- Rewards early movers;
- Capacity to encourage abatement at least cost.

PROPOSITION 1: CAP AND TRADE APPROACH

A cap and trade approach is essential to limit gaming and manipulation. The cap must be consistent with the achievement of at least a 60% cut by 2050, using a progressively lowering cap. This would mean that fewer permits would be available for each subsequent period. Longer-term caps should be set to give investors confidence in future carbon pricing.

Questions for Stakeholders:

Are there elements of other approaches which you would propose to include in a cap and trade scheme?

Baseline and credit aspects should be excluded from the scheme to prevent gaming, manipulation and uncertainty. These aspects arise through the introduction of off-sets and through administrative allocation as a means of distributing permits. Both create a heavy administrative burden, increasing the costs of the scheme, and create many possibilities for manipulation, damaging the environmental efficacy of and confidence in the scheme.

To what extent does an Australian scheme need to be consistent and compatible with other schemes internationally (and therefore facilitate linking)?

Integration with other international schemes is preferable but should not compromise the efficacy of a national ETS. This is essential in the context of base-line and credit aspects and, in particular, the creation of off-sets. Off-sets

should be excluded from the scheme to ensure that emissions reductions are maximised.

Overseas permits should be restricted to Kyoto compliant schemes.

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

The European ETS experience is informative in several ways. Most important is the enormous administrative burden of adopting a 'grandfathering' approach to the allocation of permits. Grandfathering encourages excessive lobbying and attempts at manipulation. It also involves contentious measurement and verification procedures that damage the reputation and effectiveness of the scheme. For example, Germany was finally forced to adopt 60 different versions of grandfathering and struggled with a variety of legal issues as different participants jockeyed for the most beneficial treatment. This should be avoided through the auctioning of all permits.

The European experience has also shown that a long term cap is preferable to create certainty.

PROPOSITION 2: THAT THE SCHEME BE NATIONAL AND SECTOR BASED

A national scheme is preferable, however, in the absence of the participation of all States and Territories, a smaller group of jurisdictions should initiate an ETS and proceed regardless. As far as possible, the scheme should be designed to allow future adoption by the Commonwealth.

PROPOSITION 3: SETTING THE CAP

Questions for Stakeholders:

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

The caps must be set to achieve at least a 60% emissions reduction economy wide from 1990 levels by 2050, consistent with current scientific thinking on avoidance of dangerous climate change associated with a 2°C rise in temperature.

The stationary energy sector should be the initial focus, and should meet its share of emissions reductions relative to the base year (1990) as a minimum, and preferably a higher share as this sector has the most easily available technological solutions.

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? If medium to long term caps were to be considered, how should they be determined?

Long term caps are required to deliver investment certainty and to ensure a smooth transition to a low carbon economy. Caps and targets should be set beyond the current Kyoto target period, to at least 2025. The minimum period should correspond with the investment cycles for energy infrastructure, which are in the order of 2 to 3 decades.

Setting long term targets to achieve 60% emissions reductions will help ensure that existing high carbon intensive infrastructure is retired at the end of its economic life. Between 2020 and 2035 much of Australia's coal based electricity generation capacity will be coming to the end of its economic life. This opportunity must be harnessed to achieve major emission reductions by replacing old greenhouse intensive infrastructure with zero or low emission technology.

AMP has concluded that any new base load generation needs emissions of less than 300kg of CO₂/megawatt hour if Australia is to meet long-term climate change targets.¹ Australia's electricity generation is currently around 1,000 kg of CO₂/megawatt hour and world's best practice coal generation is about 800kg CO₂/megawatt hour. The report also concludes that "even a moderate reduction in greenhouse gas emissions will be difficult to achieve unless best available fossil fuel technology [combined cycle gas turbines] is implemented for all new power stations from 2010."

So called higher efficiency coal technologies will not lead to the level of emission reduction required from the power generation sector if major reductions in greenhouse emissions are to be achieved. The use of geosequestration to deliver lower emissions is unacceptable due to the uncertainty, cost and the environmental and risk burdens placed on future generations.

While long term targets are necessary, intermediate steps are an essential element in reaching those targets, to ensure that action is taken progressively to avoid shocks to the economy and to ensure environmental effectiveness.

¹¹ AMP (2005b), Implication on Power Sector Investment of Climate Change Policy, AMP Capital Investors, Sydney.

Given uncertainty about what the level of possible future international targets for emission reduction, 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? 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?

It is the responsibility of Government to set policy to enable Australia to reduce its emissions to a level consistent with avoiding dangerous climate change. Thus the intermediate and long term targets should be set at levels generally agreed to be consistent (broadly, 60 – 80% cuts by 2050).

To ensure the ability to respond to changing science regarding climate change and the need to reduce emissions, the Government should specify that permitted emissions may be curtailed in the future, and that no indemnity will be given for carbon risk either now or in the future. This will give a further incentive to investors and industry to follow best practice and to innovate to reduce the emissions intensity of our economy.

Investor certainty is never absolute, but remains always subject to the possibility of future change in government policy. For example, a business may plan based on an assumption that tax rates will not dramatically change; however, governments remain free to change those tax rates, and businesses have no legal claims against the government if it decides to raise taxes. The “certainty” that businesses have in relation to taxation is simply an assessment, based on past experience, that governments will not radically change tax policy on a whim.

Emissions caps should not be viewed as any different. The caps should aim to give long-term certainty, but not at the expense of policy flexibility. Just as governments retain the absolute ability to change rates of taxation, so should they retain the absolute capacity to adjust pollution caps over time. In particular, changing international obligations, development of and experience with technological and behavioural techniques for emissions reductions, and further development of the science on climate change may all affect the consensus view on what amount of reductions is achievable and necessary over time.

PROPOSITION 4: SCHEME INITIALLY TO COVER THE STATIONARY ENERGY SECTOR

Initial coverage should be restricted to the stationary energy sector as this sector has limited participants, ensuring simplicity, and is most able to reduce emissions due to technological change. Other sectors could be included in the long term if it is shown that an emissions trading approach is preferable.

Coverage of the transport sector could be achieved at a later date. The multiplicity of participants in that sector could be avoided by targeting the refinery level.

Questions for Stakeholders:

What level of reporting should be required in order to establish liability and monitor compliance? Should it be at facility or company level? Should reporting requirements be implemented through existing reporting regimes (eg through state environmental laws) or under a new reporting regime? And what processes would be needed to collect data in future?

If the scheme is restricted to energy generation, then facility-level reporting and compliance would be most appropriate. Requiring entity-level reporting would introduce inequities and complexities that are unnecessary for the task of assessing performance of a relatively limited number of facilities.

The National Pollutant Inventory (NPI) is the ideal vehicle for reporting greenhouse gas emissions at a facility level.

Reporting must be public, as it is essential that the public have the ability to monitor and assess independently the effectiveness of the scheme in reducing emissions and overall compliance with emissions caps.

The NPI also has the advantage of being an existing nation-wide scheme, which is preferable to state-by-state regulation. Incorporation of greenhouse gases in the NPI would require only minor administrative adjustments and consolidation of reporting, since most energy generators already collect and report greenhouse emissions voluntarily or through various state and federal programs.

PROPOSITION 5: THAT THE SCHEME COVER ALL SIX GREENHOUSE GASES UNDER THE KYOTO PROTOCOL

The scheme should cover all six greenhouse gases under the Kyoto Protocol, however, trade-offs between different gases within participants' sites should not allow the weakening of reductions of particular gases.

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

As noted above, all permits should be auctioned. Auctioning is superior because of its consumer protection benefits, simplicity, market efficiency, and transparency.

Grandfathering on the basis of historic emissions is inequitable, inefficient, is open to manipulation and therefore reduces environmental effectiveness. This system rewards existing poor performers, and strongly disadvantages both early movers that have implemented efficiency measures and new entrants in the market. There is also a concern that there will be limited trading as each generator will have sufficient permits to offset emissions.

There is insufficient quality data available on which to base allocation by grandfathering, leading to possible legal challenges (which has been the experience in Germany). While historical information may be available, such information is of highly variable reliability. Often the information has been collected for voluntary government programs or internal initiatives, and frequently it has not been subject to any external audit or verification. In the absence of such verification, using historical information as the basis for grandfathering decisions that entail the granting of large economic benefits to industries would be unfair and lacking in credibility.

Grandfathering results in no revenue being generated. This means that Governments do not have options for structural adjustment packages. Auctioning, however, allows for structural adjustment through the recycling of revenue. This revenue can be used in a variety of ways, including transitioning of coal communities, compensation for low-income consumers, funding of energy efficiency programs or support for states with a higher carbon intensity.

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

The criteria in order of importance should be environmental outcomes, equity, simplicity, and market efficiency. Note that environmental outcomes may be severely undermined by complexities in allocation.

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

All permits should be annual. Long term permits remove some efficiency benefits from a trading system, as the marginal price of permits becomes less able to respond to market changes. Long term permits also increase the likelihood of abrupt 'steps' in energy costs. Long term permit owners have no incentive to continue participating in the market.

If permits were to be allocated by grandfathering, what historical facility level information is available to inform such allocation? Does 'grandfathering' of permits disadvantage 'early movers'?

Grandfathering should be excluded from the scheme. See above.

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

The revenue should be used for structural adjustment, in particular, protection of low income consumers from price rises (to be achieved where possible by energy efficiency improvements), for industries which will be negatively impacted by energy price rises, and for further deployment of renewable technologies.

PROPOSITION 7: THAT A PENALTY SHOULD BE SET TO ENCOURAGE COMPLIANCE AND TO ESTABLISH A PRICE CEILING

A strict compliance regime would help to ensure the effectiveness of the scheme. Participants should be required to make up any shortfall in permits as well as paying a high penalty.

The penalty level should be set well above the cost of permits and should be indexed to remain well above that level to ensure the effectiveness of the scheme.

PROPOSITION 8: THAT OFFSETS BE ALLOWED

Offsets should be excluded from the scheme to ensure effectiveness, simplicity and certainty, and to reduce manipulation.

Verification of offsets is extremely difficult and offsets may not achieve actual reductions in atmospheric concentrations of carbon dioxide. Offsets encourage the delay of action to address the underlying emissions growth in the energy sector.

Carbon sinks should also be excluded from an ETS. The inclusion of sinks would make the scheme incompatible with the existing EU emission trading scheme.

PROPOSITION 10: THAT MECHANISMS BE INCLUDED TO ALLOW A TRANSITION FOR PARTICIPANTS WHO HAVE TAKEN EARLY ABATEMENT ACTION AND NEW ENTRANTS

The scheme should reward early action. The best means of rewarding early action is to avoid grandfathering on the basis of historic emissions.