

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



11 November 2005

Dear members of the Emissions Trading Working Group

BCSE Submission on the National Emissions Trading Background Paper

Email: emissionstrading@cabinet.nsw.gov.au

The Australian Business Council for Sustainable Energy (BCSE) is an independent member-based industry association representing the broader sustainable energy industry in Australia. The BCSE has more than 270 organisations as members covering renewable, gas and distributed energy generation equipment suppliers and installers, energy retailers and generators and energy service and efficiency providers. The common feature of our membership is their interest in meeting Australia's energy needs with lower greenhouse emissions.

The BCSE welcomes the opportunity to comment on the 10 propositions for an interjurisdictional emissions trading scheme. The BCSE is a strong supporter of the introduction of an emissions trading scheme and believe it is a necessary and overdue step towards confronting what is the most serious threat facing the global community. The use of the 1990 baseline year has shielded from view the tremendous growth in greenhouse emissions in every sector other than land-use. Australia desperately needs to stop emissions growing and begin the process of progressively reducing them.

We commend the states for beginning this process and sincerely hope that any differences between jurisdictions that may emerge can be resolved satisfactorily for the larger benefit of the Australian community.

Yours sincerely

Original signed by

Ric Brazzale
Executive Director

Attachments:

Attachment 1 – The Energy Efficiency Gap – Market Failures and Policy Options

Australian Business Council for Sustainable Energy

Submission to the Interjurisdictional Working Group on Emissions Trading on the 10 Design Principles

November 2005



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Proposition 1

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

The BCSE support the implementation of a cap and trade model. However we believe it needs to be supplemented with other measures to provide greater facilitation of energy efficiency, acknowledged widely to be the cheapest form of abatement available. A cap and trade scheme incentivises energy efficiency only through its effect in increasing the price of energy. Numerous studies indicate that at least for those sectors where energy is a small proportion of overall expenditure, there is minimal sensitivity to energy price where people fail to take up cost-effective levels of energy efficiency due to bounded rationality and split incentives (refer to attachment 1 for a discussion on barriers to energy efficiency and the report: *Motivating Home Energy Action - A Handbook of What Works* prepared by Michelle Shipworth for the Australian Greenhouse Office, April 2000). In essence people have difficulty appreciating that the higher capital cost of an energy efficient product is worth it because of its energy savings over time. The NSW benchmark scheme helps to overcome this cognitive processing difficulty by enabling those who sell energy efficient product to discount the product upfront from abatement certificate revenue. This makes the decision easier for consumers and provides an incentive for intermediaries to get involved in selling energy efficiency because they can capture some of the benefit.

If a cap and trade scheme were to lead to the phase out of the NSW Greenhouse Gas Abatement Scheme before 2012 measures need to be put in place to continue to reward the demand side abatement actions recognised under the NSW scheme. Also we see considerable merit in continuing with and expanding the NSW's Energy Savings Fund concept (funded through a levy on electricity distributors) to all Australian states and territories. As the Allen Consulting Group found in their 2004 report *The Greenhouse Challenge for Energy* analysing emissions trading options (commissioned by the Victorian Government), the lowest cost outcome for a given level of abatement involved a combination of emissions trading and complementary measures to encourage energy efficiency:

The derived marginal cost of abatement for 2010 suggests the level of annual GHG abatement at \$10 per tonne of CO₂-e from technological response would be around 8 Mt with no complementary policy and 22 Mt with complementary policy. The difference between the 'with' and 'without complementary policy' curves reflects the large pool of energy efficiency that is possible with directly targeted policies. Technological abatement opportunities increase significantly by 2020. The bulk of the emissions savings at lower carbon prices are expected to come from energy efficiency.

Overall, the marginal cost analysis points to the large opportunities that are possible through enhanced energy efficiency, both at 2010 and 2020. Many of these energy efficiency opportunities are classic 'no regrets' opportunities — boosting GDP and enhancing welfare while reducing GHG emissions — while others are low cost. Full realisation of potential savings from energy efficiency will require complementary policies to overcome market imperfections.” (Page ix)

We believe there is also merit in reserving a proportion of the revenue from permit auctioning to funding programs that study, inform and incentivise action on energy efficiency on the rationale that this will, if done properly, actually help to reduce the emission trading scheme's cost on the economy. The National Appliance and Equipment Energy Efficiency Program and associated gas program, along with programs on buildings energy efficiency should have their funding for programs and enforcement increased through use of this funding source. This will enable them to improve information collection on energy use patterns and behaviour in Australia, undertake a more comprehensive compliance testing regime, expand the number of products regulated and accelerate the regulatory process.

Proposition 2

That the scheme be national and sector based

We strongly support a nationally uniform approach to emissions trading but not at the expense of having no carbon pricing scheme at all. NSW has shown clearly that it is possible to proceed with an emissions trading scheme that is not inclusive of all states and territories. If negotiations break down with one particular state or territory this may necessitate alteration in aspects of the scheme to manage leakage issues but should not prevent a multi-jurisdictional scheme from going ahead. The history of Australian federalism illustrates that national uniformity is usually achieved through steady incremental steps, with leading states providing the experience to give laggards the confidence to join-in later.

We agree with the principle of one shared target across the co-operating jurisdictions with any adjustment difficulty or special hardship for one particular state best dealt with through transfer of permit auction revenues.

In terms of developing institutions to manage an emissions trading scheme, there are several inter-jurisdictional examples from which to draw lessons and precedents including the Murray Darling Commission, and National Electricity Market institutions as well as the Australian Competition and Consumer Commission.

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

We recognise the significant constraints and uncertainty that confronts state policy makers trying to implement an emissions trading scheme outside of a long-term international agreement process. Nonetheless there are a few objectives could be used in determining the level of target that needs to be set:

1. The first thing is to ensure we avoid making major investment mistakes, that we don't make our situation significantly worse than it already is. The scheme's target should provide a signal to the market that will prevent major investments being made that have a high probability of being stranded under a future international agreement. In other words we ensure a major increase in our risk exposure and likelihood of future economic shock is averted. A clear example of such an investment might be a new baseload power plant worth several billion dollars with significant emissions exposure that cannot be inexpensively retrofitted.
2. Secondly we should strive to improve on the no major mistakes mentality and select a target that would have Australia take some economically affordable steps that will enable a steady, managed transition (as opposed to abrupt and unplanned) towards an emissions profile that is consistent with avoiding dangerous interference with the climate. One would think the very minimum characteristic of such a path would be to stop emissions growing within the very short-term and seek to achieve a GDP-emissions intensity no worse than that of today's OECD average within the next two decades.
3. Thirdly we might dare to take a leadership approach with the aim of developing a first-movers advantage in greenhouse efficient technologies and services that we might sell overseas.

In addition to the objectives above there are several other guideposts we can take from jurisdiction's policies and agreements:

- Australia's Kyoto target of 108% of 1990 levels
- The NSW Greenhouse Gas Abatement Scheme's per capita target of 7.27 tonnes of CO₂ from electricity generation by 2012
- The NSW government's commitment to stabilise greenhouse emissions at 2000 levels by 2025

- The European Emissions Trading Scheme price for a tonne of carbon dioxide.
- The NSW government's target to reduce greenhouse emissions by 60% by 2050.

If the scheme chose to adopt the cap level of Australia's Kyoto target and its timeframe of 2008-2012, this will be of little impact unless this enables our scheme to link with overseas emissions trading markets. The BCSE would not support a scheme built on the Kyoto target unless it provided this linking mechanism because it would essentially be a "do nothing" scheme. Linking on the other hand would provide additional incentive to undertake projects in Australia where our price of abatement is likely to be significantly lower than current EU emissions trading price of around \$30 AUD, with considerable investment and employment stimulation likely to be produced.

Any scheme adopted for the 2008-2012 period should not lead to a watering down in the reward for abatement currently embodied in the NSW Greenhouse Gas Abatement Scheme. Currently a number of businesses have undertaken substantial investments on the expectation that the abatement they deliver will be worth in the realm of around \$10 to \$14 per tonne. We would expect any national scheme should provide at least the same level of incentive for emissions reductions.

Longer term the minimum commitment would need to at the very least stabilise emissions and honour the NSW's government's commitment to slightly reduce greenhouse emissions to 2000 levels by 2025. While the discussion paper has only envisaged a scheme for the 2008-2012 period we believe this is entirely inadequate for an industry such as the stationary energy sector where investments with lifetimes of many decades are commonplace. Understandably international greenhouse negotiations temper the ability for states to commit much further, however we believe there may be a mechanism to manage for this eventuality.

The states could set-up a scheme that has a locked-in lifetime up to say 2012 with an legislated option that this will extend out on a rolling four year basis if no international agreement on controlling greenhouse emissions (to which Australia is a ratifying party) exists or is an imminent prospect by the close of 2011. The targets for each four year stage up to the end of 2024 should be announced at the outset of the scheme. This would provide at least some kind of confidence for investment in lower emission plant, but would explicitly inform market participants that they could not expect compensation if an international greenhouse emissions control agreement were to subsequently supercede the scheme. Also it would enable the scheme to be relatively quickly wrapped-up in the event of an international agreement coming into effect.

Based on European Emissions Trading Pricing of \$20 to \$30 per tonne Australia could achieve considerable levels of emissions reductions. Probably the stand-out area for significant emissions abatement is fuel switching from coal to gas in baseload power generation. The long-run average cost for a new combined cycle gas turbine (CCGT) in Australia is around \$45/MWh while that for coal is around \$35/MWh. In terms of emissions intensity CCGT emits around 0.4 tonnes of CO₂ while coal emits between 0.8 and 1.3 tonnes depending on age of the plant and its fuel. With carbon prices of \$20 to \$30 per tonne we expect combined cycle gas plant could make considerable in-roads into the market share of coal plant, significantly lowering emissions intensity of Australia's power generation. This is only one example of a great diversity of options open to Australia in achieving emission reductions but illustrates that Australia has room to adopt a considerably significant cut in emissions without being out-of-step with what is likely to occur internationally. When combined with some entirely feasible energy efficiency measures (such as those outlined in Appendix G of *The Greenhouse Challenge for Energy* commissioned by the Victorian Government and authored by The Allen Consulting Group [see www.greenhouse.vic.gov.au/challengeforenergy.htm#Read_position_paper for a copy of this report and its appendices]) and no doubt several unforeseen technological options that will develop once a marketplace develops, Australia could find a 2000 level target by 2025 easily achievable without exceeding the current European emissions trading price for a tonne of CO₂.

In terms of translating any economy-wide emissions target to a stationary energy sector target one needs to consider that the potential for abatement in this sector is probably far more significant than in

other sectors. Numerous studies exist published by authoritative bodies including the IEA, IPCC, US Department of Energy, Australian Greenhouse Office and other Australian state government agencies that detail assessments on the potential for significant abatement within the stationary energy sector. For this reason if any target is set specifically for the stationary energy sector (or this sector plus one or two others) it will need to require a greater scale of abatement than that required from the economy as a whole in order to increase the likelihood of achieving the economy-wide target.

Proposition 4

That the scheme initially cover the stationary energy sector

The BCSE believes there is no technical reason why the scheme could not also cover the transport sector via placing the liability on fuel wholesalers. The emissions associated with combustion of a litre of petrol, kerosene or diesel are well understood with a reasonably high level of accuracy. And by extending the scheme to this sector we increase the options for abatement, potentially reducing economic costs.

Proposition 5

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

The BCSE agrees with this proposition.

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

Mechanisms for easing structural adjustment and compensation should be done via direct financial transfers rather than the administrative allocation of permits at no or heavily discounted cost.

Auctioning will ensure permits are provided to those who find them of most value and will avoid a situation where businesses are incentivised to **not** take early action in order to maximise their claim for administratively allocated discounted permits. Administrative allocation will require making ex-ante decisions about impacts, when it is probably only after the scheme is introduced that any soundly informed judgements can be made about who carries the greatest vulnerability to emissions trading.

In addition, one needs to ask which stakeholders associated with an emissions exposed business have the least ability to shield themselves from the potential negative impacts of emissions trading? Is it shareholders or people who work for emissions exposed businesses? Shareholders can very easily diversify their portfolio of shares to manage their exposure to an emissions trading scheme, they could even buy various futures instruments to hedge their risk. Workers on the other hand typically depend almost wholly on the one business for their entire income, with minimal if any ability to take a portfolio of jobs with varying carbon risk exposures. By providing discounted or free permits to a business the person being compensated is the shareholder, but the person who is likely to bear the greatest impact is the worker and their local community if the business ends up closing. For this reason it may be best for the government to reserve the revenue from permits by auctioning, so that it can compensate those most vulnerable.

The BCSE is strongly in favour of an emissions trading scheme and believes a carbon price is the most fundamental policy to achieve effective and efficient reduction in greenhouse emissions. For that reason we have a strong interest in ensuring it has community and therefore political support. Critical to this will be providing reassurance to those people most vulnerable to emissions trading that they will be supported in coping with and adjusting to structural change. By administratively allocating permits to businesses at discounted or no cost the government will pass-up the revenue to fund such programs.

If the scheme chooses to administratively allocate some level of permits, the allocation methodology should be open to stakeholder scrutiny, applied consistently and ideally not be open to manipulation or significantly differing interpretations.

Proposition 7

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

The BCSE supports this proposition, however making a judgement about the appropriate penalty price/price ceiling is heavily dependent on the level of target the government decides it wishes to achieve. In addition a price ceiling may make our scheme incompatible with that of Europe's and therefore prevent linking of the schemes, in such a case we would favour scrapping of the price ceiling to enable linking. The BCSE would not support a situation where jurisdictions selected a highly ambitious target and then imposed a penalty/ceiling price that meant it was highly likely most participants would choose to pay the penalty price. This is likely to undermine the integrity of the scheme in the eye of the general public and make it appear more as a straight tax rather than an environmental initiative.

In terms of the 2008-12 period, the penalty should not be any lower than that currently in place for the NSW greenhouse gas abatement scheme. But if jurisdictions wish to upgrade the stringency of the target beyond that embodied within the NSW scheme, it would be necessary to increase the penalty price. If the scheme is to go beyond 2012 the penalty price needs to be steadily increased with inflation and also to reflect the extent of the abatement task. The penalty would need to be in the order of \$20 to \$30 post the 2012 period to achieve stabilisation and ultimately reductions in total emissions.

It is important to acknowledge that a penalty price providing a price cap is of important reassurance to a community that is completely unfamiliar with the likely impacts of an emissions trading scheme and can help to address any potential misinterpretations that might emerge in the media and other sources.

Proposition 8

That offsets be allowed

We can see no reason why offsets should not be recognised under the scheme provided they meet with IPCC accounting standards, and provide a secure form of abatement that is capable of being measured on a repeatable and accurate basis. Offsets increase the number of options available for realising cost-effective abatement and in the case of methane destruction is one the cheapest abatement options available in Australia. All abatement outside of stationary energy that is already recognised by the NSW Greenhouse Gas Abatement Scheme, such as tree planting and reduction of fugitive emissions, should be recognised as allowable offsets by any future emissions trading scheme.

Proposition 9

That mechanisms be included to address adverse effects and structural adjustment

As discussed under proposition 6, mechanisms for easing structural adjustment and compensation should be done via direct financial transfers rather than the administrative allocation of permits at no or heavily discounted cost. Auctioning will ensure permits are provided to those who find them of most value and will avoid a situation where businesses are incentivised to **not** take early action in order to maximise their claim for administratively allocated discounted permits. Administrative allocation will require making ex-ante decisions about impacts when it is probably only after the scheme is introduced that any soundly informed judgements can be made about who carries the greatest vulnerability to emissions trading.

In addition, one needs to ask which stakeholders associated with an emissions exposed business have the least ability to shield themselves from the potential negative impacts of emissions trading? Is it shareholders or people who work for emissions exposed businesses? Shareholders can very easily diversify their portfolio of shares to manage their exposure to an emissions trading scheme, they could

even buy various futures instruments to hedge their risk. Workers on the other hand typically depend almost wholly on the one business for their entire income, with minimal if any ability to take a portfolio of jobs with varying carbon risk exposures. By providing discounted or free permits to a business the person being compensated is the shareholder, but the person who is likely to bear the greatest impact is the worker and their community if the business ends up closing. For this reason it may be best for the government to reserve the revenue from permits by auctioning them, so that it can help those most vulnerable to find new areas of employment.

Another mechanism that will assist in easing in the impact of emissions trading on energy consumers is the establishment of programs to facilitate improved energy efficiency as discussed in earlier sections of this submission. The increased cost of a unit of energy driven by emissions trading can be offset by the fact that the energy consumer does not need to consume as much energy for given level of light or heat or cooling etc.

What is critical is that any assistance mechanism set-up by governments not inhibit structural change but rather make it easier for affected members of the community to cope with this change. Therefore the government should not give pensioners an emission trading compensatory discount on their electricity bill but rather a straight financial payment or help with their health care bill.

Proposition 10

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

Proposition 10 is likely to be a cumbersome mechanism that could be largely avoided by allocating emissions via auctioning. Determining and quantifying “early action” is likely to be a difficult exercise subject to significant interpretation and time consuming analytical exercises. If permits are entirely auctioned this becomes largely unnecessary because emitters will be rewarded for early action by having to buy less permits (or less electricity). Also auctioning will avoid the need for any transition mechanisms for new entrants because they will face the same costs faced by incumbents who would have had to also buy permits.