



## **INITIAL SUBMISSION**

# **A NATIONAL EMISSIONS TRADING SCHEME: BACKGROUND PAPER CONSULTATION**

**November 2005**

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## **Executive Summary**

The EUAA recognises that greenhouse gas emissions is an important issue for the environment, the community and for industry. It is therefore, pleased to make a submission on the potential design of a national emissions trading scheme in Australia.

We believe that the introduction of any emissions trading scheme is likely to have a significant impact on Australian industry, primarily through increased energy costs. Considering that Australia is a small open economy that relies heavily on exports, minimising the impacts of any scheme would be very important. A central component in minimising the impacts will be the removal of all other greenhouse programs that apply to the sectors covered by the emissions trading scheme.

At this stage, the EUAA is not in a position to support a national emissions trading scheme as proposed in the National Emissions Trading Taskforce (NETT) Background Paper but welcomes the release of the Background Paper for consultation. The EUAA requires more debate and discussion, as well as information to tease out the details and impacts of a national emissions trading scheme before it would be able to make its mind up. It will use the NETT process to assist in this.

The EUAA believes that it is very important that a national approach to greenhouse focus on achieving emissions reductions at least cost and without damage to our competitiveness.

Evidence now emerging from the EU suggests that the scheme introduced there in January 2005 has had some costly and unintended consequences that are damaging industry competitiveness: power prices have increased in part due to emissions trading (German industry estimates a 5 billion euro cost); 40-70% of the CO<sub>2</sub> cost has been passed on to electricity users in the form of higher prices, notwithstanding that permits were allocated freely to avoid such cost increases; and modelling suggests that a CO<sub>2</sub> allowance cost of €20 will increase average electricity prices in Germany, France, the Netherlands and Belgium by between 13-39 per cent.

This suggests the need for care, caution and considered decision making on any national emissions trading scheme.

Any national emissions trading scheme should consider the following elements:

- The use of a *cap and trade* approach but not discount totally the use of a *baseline and credit* approach;
- Any scheme should be national and as broad as possible;
- Although the Kyoto target could be used as the guideline for setting any cap, which should also be national, there is value in considering a flexible mechanism to take account of our conditions and economic circumstances;
- Any scheme should initially include the transport sector and any other sectors that can be efficiently included;
- Large users may be able to obtain a benefit from opting into any scheme, as it may provide a counterbalance to market power, as well as offsetting higher energy costs;

- Existing reporting regimes should be used wherever possible;
- Any scheme should only include those gases that are emitted by covered sectors;
- The allocation of permits is a vexed issue that requires careful consideration and, in principle, should be allocated through a grandfathering process without a fixed fee; fixed fees are nothing more than revenue streams for Governments; auctions might also be considered with revenue used to offset any adjustment costs;
- Penalties for non-compliance should balance the need to encourage greenhouse abatement but also put a cap on the potential costs of the scheme;
- Offsets could be included if it can be proven that this enhances economic efficiency and can be done cost effectively;
- Structural adjustment mechanisms should be provided to those who experience the most impact from the scheme – significantly affected end users; and
- Mechanisms should be included that allow for the recognition of early action.

Notwithstanding the above, we note that the details of any national emissions trading scheme remain somewhat vague and will need to be fleshed out and discussed with energy users before any scheme is considered. The Background Paper is an attempt to elicit comment and debate on matters surrounding any national emissions trading scheme, but many of the matters to consider are complex, controversial and in need of more detailed assessment. A lot more work is needed before there could be any consideration of such a scheme. The NETT is one means of achieving this.

We also note that there remains a lack of robust information about the costs and benefits of any national emissions trading scheme. Energy users will need to be provided with such information (including robust modelling of costs, benefits and economic impacts) and given an opportunity to comment before they could support any such scheme. This is not provided and the Background Paper, which although useful, has a narrow scope of considering more the issues around the design of any scheme. We welcome the NETT's indication that they intend to commission such modelling work. It will need to be published and subject to the highest degree of public scrutiny.

We also have some doubts about the Constitutional validity – and the desirability and likelihood – of States and Territories agreeing to implement emissions trading without involvement from the Commonwealth. It is our strong preference, on both Constitutional and national consistency grounds, that any action to deal with emissions abatement be implemented at Commonwealth level. Energy users with international, national and multi-state operations would be the main parties at risk from sub-optimal implementation, as the EU scheme shows.

## **Introduction**

The Energy Users Association of Australia (EUAA) welcomes the opportunity to provide comments on the Inter-jurisdictional Working Group on Emission Trading's (now called the National Emissions Trading Task Force, or NETT), *Background Paper* entitled *A National Emissions Trading Scheme*.

The EUAA is a non-profit organisation focused entirely on energy issues. Members determine EUAA policy and direction. The EUAA represents a wide spectrum of end-users in all Australian States and has over 80 members, predominantly business end-users with activities across all states and many sectors of the economy. These include many of Australia's largest gas and electricity users. EUAA activities cover both national and sub-national issues. See [www.euaa.com.au](http://www.euaa.com.au) for more information on the EUAA.

The introduction of an emissions trading scheme is likely to have a significant impact on the majority of our members. Our members are large energy users and, as a result, a policy that can potentially increase the cost of energy significantly will have large potential ramifications for their costs and competitiveness.

At this stage, the EUAA is not in a position to support a national emissions trading scheme as proposed in the National Emissions Trading Taskforce (NETT) Background Paper but welcomes the release of the Paper for consultation. It requires more debate and discussion, as well as information to tease out the details and impacts of a national emissions trading scheme before we develop our position. We intend to use the NETT process, among other things, to assist us in this.

We do recognise the importance of a nationally consistent approach to greenhouse gas emissions and that the lack of such a policy creates costs and uncertainties of its own, including for our members. We also believe that it is highly desirable that a national approach to greenhouse focus on achieving emissions reductions at least cost and without damage to our competitiveness.

It is possible that a market-based approach, such as emissions trading, along with technological advances supporting lower emissions could be the best way to achieve this. However, this is yet to be shown conclusively and the details of any scheme, as well as a good understanding of its likely costs, are imperative. It is important that the NETT address these issues as part of its work on a national emissions trading scheme. Energy users, in particular, need to have an understanding of the costs and impacts of any such scheme.

It is our view that the primary purpose of an emissions trading scheme is to provide a market signal for the reductions of greenhouse emissions in the economy. If the market signals were effective, it would therefore remove the need for any further intervention. This is because, theoretically, the market will ensure that the most efficient and cost effective options for reducing emissions is undertaken.

Currently our members are required to adhere to a number of greenhouse and energy efficiency polices instigated by Governments. These schemes include reporting energy use in several jurisdictions, including the Commonwealth, as well as facing the

costs created by schemes such as the Mandatory Renewable Energy Target (MRET), the NSW Greenhouse Gas Abatement Scheme (GGAS) and the QLD 13% Gas Scheme (GECs).

The EUAA believes that other intrusive and costly policy instruments, in addition to any emissions trading scheme, would simply add costs to industry and distort the signals from the emissions trading scheme. Furthermore, for any such suite of related measures to be fair and reasonable ‘additionality’ would need to be included. The difficulties that this creates are well known and apparent in Europe, as well as in schemes such as GGAS. It creates a minefield of potential calculation issues. Therefore, these duplicating schemes should be abandoned if a national emissions trading scheme were developed.

We note that the details of any national emissions trading scheme remain somewhat vague and will need to be fleshed out and discussed with energy users before any scheme is considered further. The Background Paper is an attempt to elicit comment and debate on matters surrounding any national emissions trading scheme, but the matters contained in it are complex and controversial. A lot more work is needed before there could be any consideration of any such scheme. The NETT is one means of achieving further progress towards consideration of the impact and desirability of any national emissions trading scheme.

We also note that there remains a lack of robust information about the costs and benefits of any national emissions trading scheme. Energy users will need to be provided with such information (including robust modelling of costs, benefits and economic impacts) and given an opportunity to comment before they could support any such scheme. This has not yet been provided and the Background Paper, although useful, has a narrow scope of considering more the issues around the design of any scheme. We welcome the NETT’s indication that they intend to commission such modelling work. It will need to be published and subject to the highest degree of public scrutiny (including by energy users) given the significant impact that any emissions trading scheme would have.

In addition, the ability of the States to introduce a national emissions trading scheme raises potential Constitutional Issues that need to be considered and properly debated. The NETT is one mechanism for doing so and we would expect to see this matter subject to public debate.

Aside from this, we have some doubts about the desirability and likelihood of States and Territories agreeing to implement emissions trading without involvement from the Commonwealth. It is our strong preference, on both Constitutional and national consistency grounds, that any action to deal with emissions abatement be implemented at Commonwealth level. For energy users with international, national and multi-state operations, who would be among the main parties affected, the risks of fragmentation, inconsistency and trade-offs in State schemes (even ‘national’ ones), either upon implementation, or in the future, are considerable.

Some concerning aspects about the EU emissions trading scheme – the most comprehensive scheme yet introduced and the one often referred to by proponents of emissions trading – have begun to emerge. Some of these concerns are referred to

later in the submission in terms of the design aspects of emissions trading. More generally, European industry and observers of the EU scheme have been expressing alarm about some of the impacts including:

- The industrial power consumers' association (VIK) has claimed that the German electrical power industry makes around five billion euros in 'unwarranted' profits each year from European emissions trading. The windfall profits are apparently achievable thanks to the "poorly formulated legal basis for emissions trading" and are being paid for by German electricity consumers.
- Finnish consumers and industry might end up paying nearly €1 billion more for their electricity if the average yearly price of a CO<sub>2</sub> allowance is €20 and the government does not succeed in preventing the producers from collecting the extra revenues they have earned passing on the costs of emissions trading.
- A report by the energy research centre ECN concluded that the electricity producers have passed on an average of 40-70 per cent of the CO<sub>2</sub> price to the electricity prices in the Netherlands, Belgium, Germany and France. Modelling work also showed significant increases in power prices under the EU scheme. With a CO<sub>2</sub> allowance cost of €20, the increases averaged between 13-39 per cent for Germany, France, the Netherlands and Belgium.

The remainder of this submission will comment on the issues for consideration, as well as each of the propositions as they are presented in the Background Paper. As mentioned above, at this stage the EUAA is neither supporting nor opposing a national emissions trading scheme as outlined in the Background Paper and nothing in what follows should be construed otherwise.

### **Issues for Consideration**

We note that the NETT identified a list of issues to be considered in developing a preferred emissions trading model. We believe that a majority of these issues will be very important for our members. In particular, we consider further work to address the following issues and examine their impacts in detail to be particularly important:

- Setting the targets and the associated penalties;
- Minimising administrative costs;
- The coverage of sectors;
- Minimising the impact on trade exposed and energy intensive sectors;
- Offsets;
- Integration with existing schemes;
- Ensure fairness for early movers;
- Allowances for new entrants; and
- Liquidity in the market both domestically and internationally.

The detailed implementation of any emissions trading scheme around issues such as these is very important to energy users and raises potential serious impacts and costs for them. They need to be aware and fully informed of such matters. Addressing these issues is therefore of primary importance to our members and their views of the success of any scheme. It is already becoming clear from the EU emissions trading scheme that some significant costs have been imposed on energy users and there have been some unforeseen consequences (eg see elsewhere in this submission). Australia

should take lessons from this and ensure that there is detailed attention paid to how any emissions trading scheme will be implemented and what its impacts will be. This needs to be handled with care and without rushing into hasty decision-making in what would be a significant policy change. The risks and costs of making mistakes can be potentially very damaging.

Our views on and concerns about the above issues are discussed throughout the remainder of this submission. Nothing in what is said there should be construed as implying our support for any emissions trading scheme at this stage.

**Proposition 1 – That a cap and trade approach be used as the basis for the scheme design**

The Background Paper sees advantages in the use of a *cap and trade* approach for the design of any emissions trading scheme over the main alternative *baseline and credit* method.

Some of the advantages that a cap and trade approach may have are to:

- Ensure consistency with other international schemes;
- Aid in minimising the administrative costs of the scheme; and
- Provide a greater potential to aid in liquidity of the trading market.

It is important that any regulatory intervention is conducted in a simple and cost effective manner. It is widely acknowledged that, because the EU developed an emissions trading scheme first, it may have effectively set a precedent for other schemes that are developed. It may, therefore, be important that any Australian scheme follows this precedent for a number of reasons, including to:

- Facilitate an international trading market for permits;
- Minimise regulatory risk; and
- Minimise costs by ensuring a consistent set of trading rules.

However, this should be set against the strengths and weaknesses of the EU scheme (see comments elsewhere in this submission) and should also consider the needs and characteristics of Australia. Clearly, slavishly following a ‘bad’ precedent or doing something that runs counter to our interests would not be sound policy.

Theoretically, a cap and trade approach has the potential to limit the administrative costs of any scheme compared to a baseline and credit approach. Under a baseline and credit approach, companies would be required to apply to the regulator to approve any credits as they may develop. In addition, the problems of defining the baseline would be likely to prove difficult. This could entail costs, intrusions and create delays in providing credits to customers.

A cap and trade approach could also provide a greater possibility of increased liquidity in the market. This is because the credits would already be in existence and able to be traded as early as possible. Under a baseline and credit approach, credits would only be created when a party can prove that credits exist. Any delays in approving credits would limit the amount of trading that could occur. Delays or a

lack of credits that leads to reduced trading would distort the economic signals for greenhouse emission reduction and increase costs. This is because the signals will not be as clear and emitters may make bad decisions based on inefficient information.

**Proposition 2 – That the scheme be national and sector based**

The EUAA considers that, because emission targets should desirably be set on a national basis, any emissions trading scheme should also apply on a similar basis. For any scheme to be successful it is imperative that it be national and sector based. The alternative, of a scheme based on state emissions, would be inefficient, more costly and create perverse outcomes.

The Australian energy industry is currently undergoing a process of nationalisation after a period of separate rules and obligations in each jurisdiction. The Ministerial Council on Energy (MCE) considered that this process was inefficient and that, to improve the effectiveness of the market, a national approach was needed. The example of separate energy market obligations in state jurisdictions in Australia highlights the difficulties that can occur with different regulatory obligations.

It could be expected that, if any scheme were designed along state boundaries, each jurisdiction would have different requirements under the scheme. As a result, discriminatory or conflicting provisions would likely be developed in various states. This would deliver inefficient outcomes and constrain Australia's international competitiveness as many of Australia's stationary energy users – and some providers – operate in more than one jurisdiction. Variation across states could also create bias and lead to inefficient investment into or away from particular jurisdictions.

The EUAA, therefore, agrees with Proposition Two that any scheme be national.

We note, however, that reducing greenhouse gas emissions are a global matter and that a global response is really warranted. Imposing a national scheme that ignores this fact could merely impose unnecessary costs on the energy sector and the economy. This is especially the case as Australia produces only about 1.5% of global greenhouse gases (although its per capita emissions are relatively high) and can have only a limited impact on global greenhouse gas abatement. To seek to have a large global impact would not only be very expensive but of limited use in a global context. It would also be very damaging to the competitiveness of our major energy using industries and to future investment in these.

**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**

The Background Paper points out that it is essential that an overall national emissions abatement target be considered when setting the cap. While not formally signing the Kyoto Agreement, the Commonwealth Government has maintained its intention to meet the Kyoto target. Therefore, the target could be the primary guideline for setting the cap under any emissions trading scheme. This would include using the same base year as the Kyoto target (ie 1990), as it would prove too complex to allocate responsibilities with a different base year.

As noted in the Background Paper, setting targets past the initial Kyoto period has some inherent risks and obviously we would not support an onerous target. However, we consider that it is important that some guidance on potential abatement targets is provided in order to enable signals for investment into the future and that any target should be phased in over time in order to give industry time to adjust. Governments should consider using best estimates on what the future abatement targets might be and set a range in order to facilitate the development of permits. By setting a range of future abatement levels, the risk of error will be minimised, while also allowing for economic signals to prevail.

Mechanisms have also been suggested elsewhere that would tie the severity of any emissions trading targets to economic cycles, so that during downturns the target would be relaxed to allow the economy greater scope to adjust. One risk here is that it implies the need for some 'catch up' once the economy returns to higher growth.

The concept that flexible targets with very long time horizons be used in any emissions trading scheme could also be examined and subject to debate by NETT.

In allocating responsibilities for emissions, great care is required in order to ensure that specific sectors are not taking on more burdens for emissions than they should. A miss-allocation of emission responsibilities would lead to inefficient outcomes and discrimination towards certain sectors that had higher responsibilities than they justified.

The EUAA is of the view that as many sectors as possible (including non-stationary sectors) should be included in any scheme. However, even if this is the case, mechanisms will still need to be developed in order to allocate responsibilities between sectors. Where a suitable theoretical mechanism is not available to allocate responsibilities, some kind of market mechanism to allocate responsibility could be examined. Increasing the number of sectors participating in a scheme may help in facilitating a market approach to allocating responsibilities and spread the burden of any scheme.

#### **Proposition 4 – that the scheme initially cover the stationary energy sector**

The Background Paper has said that the production side of the supply chain would be best placed to hold the liability for the scheme. It argues that energy users are not in a good position to manage the carbon intensity of their energy they use. Therefore, those that produce the carbon should be the liable party for the scheme. By making the production side liable, price signals will be better provided to end-users. By making available price signals, users will be better able to make decisions regarding their energy usage. This would include the source of energy, as well as the amount of energy consumed.

The EUAA has some concerns about the potential for the production side to abuse market power and obtain windfall gains from any emissions trading scheme. We consider it imperative that mechanisms are included to ensure that the market is not being manipulated.

Some of our members are international companies and are therefore exposed to the EU scheme. They have indicated to us that there have been some problems associated with the generators holding the permits for the scheme. In effect, they claim that the scheme has not reduced emissions, but has just increased the price of energy, including for off-peak times. Members have informed us that generators have played the market such that they will only generate when the price of electricity is high enough to obtain a benefit above the price they could obtain from the carbon credits created by not generating. This type of action leads to the price of electricity going up further over time.

There is also evidence emerging from the EU to suggest that the initial allocation of permits to the supply side has created problems. For example, there have been complaints in both Germany and the Netherlands that generators have used their market power to inflate electricity prices and take windfall gains from the EU scheme.

The EUAA and its members are of the view that methods should be investigated to try and minimise the ability of generators to 'play the market'. One proposal may be to give energy users the permits (or some of them) in order to ensure there is a higher degree of countervailing power in the market away from the generators. A method such as this would provide more efficient solutions to ensuring the efficiency of any scheme than simple market monitoring approaches, which often fail to recognise market abuses or only do so after the event.

One of our members is currently negotiating with their European colleagues to obtain some research and modelling that has been done to highlight the impact that generator gaming has had on the cost of electricity. There is some evidence to suggest that generator gaming alone has caused a 65 per cent increase in the price of electricity. When we can obtain this information we would like to present it to the NETT for consideration.

When determining which stationary generators are eligible for credits, it will be important to minimise the opportunity for firms to abuse market power. The result of such a principle may be to limit the scheme only to emitting generators. If non-emitting generators, such as renewable generators, were included in the scheme they would hold the majority of credits in the market. Therefore, as a dominant player, they may be able to exert some power over the market and set prices. This situation should be avoided as it will create market inefficiencies and distort investment.

The EUAA agrees with the following statement in the Background Paper:

*'In general, the broader the coverage of the emissions trading scheme the more abatement options become available leading to greater potential for least-cost abatement to meet the overall cap'*

In addition to this point, the EUAA is of the view that there are a number of benefits that would be derived by including other sectors into the scheme. One such benefit would include providing increased long-term certainty to the market. Considering the EU is currently working on including the transport sector into its scheme, it is important for the NETT to consider it for inclusion into any Australian scheme.

While the Background Paper suggests that including other sectors would significantly increase administration costs, we are yet to see clear evidence that this is the case. The EUAA believes that, if the correct point of accountability can be determined, the costs of extending any scheme can be reduced. Therefore, it is better to develop a model at the outset that includes transport in order to increase certainty, optimise coverage and remove regulatory risk.

Including the transport sector into the scheme would also facilitate increased trading in the market for credits. Such increased trading would improve liquidity in the market and ensure that more efficient price signals are provided. It is our understanding that, if the scheme only applies to the stationary energy sector, only around 150 facilities will be included. This compares with over 10,000 facilities for the EU scheme. With such a small number of participants, liquidity will be lower and the opportunities for the abuse of market power increased.

Where sectors are not able to trade at all, due to issues such as measurement or administrative costs, we consider that it would be appropriate that the cost of emissions still be reflected. This could be done through a flat tax onto their costs. The revenue from the tax could then be used to help towards structural adjustment issues, as well as the costs of any emissions trading scheme.

If liability falls on generators, we believe that there should still be scope to allow large downstream users to opt into the scheme and take over liability responsibility for emissions resulting from their energy use. In some circumstances large energy users are able to impact the level of emissions they produce. For instance, they can reduce CO<sub>2</sub> by using steam more efficiently. Therefore, large users should be able to obtain an advantage for the emissions that they are able to abate.

Allowing users to opt into the scheme would provide a number of advantages. For instance, large energy users would be able to offset the increases in energy costs that would occur as a result of the scheme. Through the ability to sell carbon credits on the market, large users would be able to recoup some of the additional energy costs that they would face. In addition, allowing large users to opt into the scheme may reduce the ability of generators to exhibit market power. The basis for this view is that, with more participants in the market, liquidity would be improved, thereby reducing the capacity for market power abuse.

We note that the NSW GGAS scheme provides for large user participation and some EUAA members are involved.

In terms of reporting, the EUAA supports using existing reporting regimes wherever possible. The basis for this view is that the administrative costs of the scheme should be minimised at all times.

### **Proposition 5 – That the scheme cover all six greenhouse gases under the Kyoto Protocol**

The EUAA proposes that only those gases that covered sectors emit should be included under any scheme that is developed, noting our support for broad coverage of emitting sectors. It is our understanding that, if the stationary energy sector is the

only covered sector, the main gas covered would be CO<sub>2</sub>. In this situation, the reporting of additional gases would add no benefit while adding costs.

We note that the EU scheme only reports CO<sub>2</sub> but that consideration is being given to including other gases and sectors. As previously stated, where possible and sensible consistency with that scheme would seem to offer some advantages. However, the matter should be also considered in the context of Australian conditions and economic characteristics. Should other sectors be included that emit other gasses, these should be included in any scheme.

**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.**

When companies made past investments in new generation they did so in a world without a price for the carbon they emit. As a result, the price of carbon was not a component in making the investment decision. If it was a component, it is possible that the project may not have been economic and it may not have gone ahead. On this basis, we do not consider it fair to force the cost of permits onto businesses when they were not reasonably able to factor the cost into their business plans.

One of the options put forward in the Background Paper is to charge a fixed fee for permits. Of all the options presented, paying a fixed fee for permits would be the most inefficient and undesirable option. The use of a fixed fee for permits cannot be justified on economic grounds, as it provides no signals to emitters. The use of a fixed fee would simply be a revenue raising tax on industry for a government-initiated policy, ostensibly introduced on the grounds of emissions abatement (not taxation). Governments already have a suite of tax options available and should use these to raise any additional revenue they seek.

We do not consider that it would be appropriate for revenue from an emissions trading scheme to be appropriated by governments for budgetary reasons as this may leave the door open for inefficiencies through administration and economic losses to society.

Indeed, if industry behaves well under the scheme, they could potentially avoid all costs in order to be compliant. That is, an emitter could make economic investments that allow it to remain within its permitted allocation of emissions and therefore, not face any additional costs of buying credits or paying penalties. On this basis, liable parties should not be forced to buy permits when they have already been performing within their rights to emit greenhouse gases up until this point in time.

It is also important that the allocation of permits recognises past performance and rewards early movers.

Where liable parties have made efforts to reduce their emissions, this should be rewarded through the allocation of permits. Otherwise, those who have done the hard work in the past will be placed at a disadvantage to those who have made no effort towards emission reductions.

Indeed, not recognising past performance could allow some parties to make windfall gains. This is because those who are yet to act on emissions reductions will be able to make larger and more economical gains in the first periods than those who have already taken action. Therefore, they will have more excess credits than those liable parties that have previously taken abatement action. Any excess credits sold by those who previously did not take abatement action would be considered a windfall gain.

The EUAA considers it important that specific arrangements be made for new entrants.

It is firstly important to clarify what a new entrant may mean. It is our view that a new entrant is best defined as either a new entity or a capacity expansion. Such a definition would avoid the possibility of companies seeking capacity expansions by simply forming a new company to obtain a carbon permit benefit.

Energy costs can be minimised (and abatements improved) through the introduction of new generation into the market, thereby increasing competition. Therefore, we consider that it is important that there are as few barriers to the entry for new generation as possible. Setting aside permits for new entrants would facilitate the reduction of barriers to entry and should be considered.

In the EU, the introduction of emissions trading was initially on the basis of free administrative allocations to electricity producers. This has created a raft of problems. As mentioned above, there have been a series of complaints in Germany, the Netherlands and Finland about liable parties taking windfall profits by passing on the 'costs' of emissions trading in higher power prices. Industry has expressed the view that permits were allocated free to generators to avoid higher power prices being foisted on them – but now this is exactly what is happening.

Ministers have come under pressure and the competition authorities have begun investigations. There is now some discussion about the desirability of auctioning off permits in the second round and also allocating fewer permits to generators.

Taking the above points into consideration, the allocation of permits should be on the basis of equity and cost minimisation. By using this principle for allocation, Governments can ensure that market distortions are minimised and that allocation is conducted as efficiently and effectively as possible. Should any fee be applicable to the allocation of permits, the revenue should only be used to assist the most detrimentally affected industries and should not be appropriated to consolidated revenue.

**Proposition 7 – That a penalty should be set to encourage compliance and to establish a price ceiling for the permit market**

The setting of the penalty is an important issue that requires careful consideration so that the correct incentives are in place to efficiently reduce emissions. However, this needs to be balanced with ensuring that the costs of the scheme do not overly damage Australia's economic prospects. The EUAA considers that it is potentially dangerous to set a penalty such that emission reductions are achieved "at any cost". This is especially important considering Australia is a small open economy that is heavily

influenced by international markets and has a number of important trade exposed energy intensive industries.

In order to provide a degree of protection from and certainty about any scheme, the penalty could be set as an upper bound to the price of permits. Should the penalty be too low, it is unlikely to provide sufficient incentives for emissions abatement. However, if the price is set too high, there is the potential for the costs of any scheme to increase and to outweigh any benefits achieved through emissions reductions.

In this regard, consistency with other schemes could be important when setting the upper bound, or cap. If some consistency can be gained with other schemes, it could allow comparisons and potentially increased trading between schemes in the future. Considering that Australia already has a number of similar schemes, such as the NSW GGAS, consistency with these schemes could allow for a more streamlined conversion to any national emissions trading scheme as the permits are likely to have similar values under both schemes.

### **Proposition 8 – That offsets be allowed**

The EUAA believes that if as many sectors as possible are included in the scheme, the need to use offsets would be greatly diminished. However, if there is consideration of the use of offsets, the costs versus the benefits of using them should be carefully weighed up.

The use of offsets can provide benefits by allowing the stationary energy sector to reach their emission targets at a lower cost. This can be done by using offsets that would, on balance, reduce their emission levels but allow them to maintain emissions from their primary sites.

Offsets also create costs for both the regulator and the liable party when they are used. The main costs that are derived from the use of offsets are the administrative costs and the costs of any associated error. These costs come about where the regulator has to verify the offsets in order to ascertain if they are legitimate for the purposes of any scheme.

In light of the benefits and costs associated with offsets, the EUAA believes that it is important that a thorough economic assessment is conducted prior to offsets being included in any scheme. The EUAA submits that offsets should only be used where it is clear that the benefits of their use will outweigh the costs.

### **Proposition 9 – That mechanisms be included to address adverse effects and structural adjustment**

It is our understanding, from attending the recent NETT briefing sessions, that the structural adjustment provisions are targeted towards the stationary generation proponents. The EUAA considers that this is a fundamental flaw in the scheme outlined in the Background Paper. While we support the concept of mechanisms to address structural adjustment, we have reservations about targeting these to the stationary generation owners.

It is quite clear that, if stationary generation is the liable party for any scheme, they will pass the costs of any scheme down to the users. As a result, it will be energy users that will bear a large portion of the costs of the scheme. Considering a majority of Australia's large energy users are export-focused companies, the additional costs of energy resulting from any scheme will impact on their international competitiveness.

There are two main impacts that may occur as a result of the higher energy costs to Australian industry. The first is that Australian industry will be less competitive on an international level. A reduction in Australia's international competitiveness would lead to a fall in exports and an increase in imports. Such a result would have serious impacts on the national economy over a wide variety of sectors, including in investment and jobs.

A second major impact that may occur from the increased energy costs stemming from any scheme is that some companies may decide to move their operations outside of Australia, especially to nations that do not value carbon. There are a number of developing countries in this category with whom Australia competes for products and investment. This result would have obvious negative impacts in terms of lost economic activity, as well as employment losses.

Considering the potential consequences that any scheme could have on the Australian economy, the EUAA is of the view that the structural adjustment measures should be targeted towards those industries that would pay the bulk of the costs of the scheme – large energy users. By applying structural adjustment measures to large energy users, Governments can be sure that support is provided directly to those it will impact the most. Alternatively, if the support was provided to the stationary energy sector, it is possible that the generators will still pass on the costs of the scheme while holding onto any benefits derived from the structural adjustment measures. The reason why this may occur is that the stationary energy sector is not directly exposed to international markets and therefore does not face the same competitive pressures as many large energy users.

**Proposition 10 – That mechanisms be included to allow a transition for participants who have taken early abatement action and new entrants**

As previously stated, the EUAA strongly supports mechanisms that allow a transition for participants who have taken early abatement action. Without recognition of prior action some participants would be greatly disadvantaged. In addition, some liable parties may delay taking abatement action if there is a prospect of an emissions trading scheme being introduced.