

22 December 2006

Ms Anthea Harris
National Emissions Trading Taskforce Secretariat
The Cabinet Office
GPO Box 5341
SYDNEY NSW 2000

Via email: submissions@emissionstrading.net.au

Dear Anthea

Re: Submission to the National Emissions Trading Taskforce

Pacific Hydro is pleased to have the opportunity to provide a submission in response to the *Discussion Paper* prepared by the National Emissions Trading Taskforce. Pacific Hydro supports the direction in the *Discussion Paper* and sees it as an important step in developing a uniform and operational carbon trading scheme in Australia. Pacific Hydro wishes to commend the Taskforce on the work it has performed thus far.

Pacific Hydro believes that a carbon trading scheme is an important economic tool to be used as a means of altering the energy intensity profile of Australia's energy sector and ensuring that Australia's energy sector remains successful in a carbon constrained low emissions economy. Future success in the sector should be measured in terms of long term energy security, internationally competitive energy prices and little or no greenhouse gas emissions.

Pacific Hydro supports NETS because it has the potential to assist the latter two objectives of emissions reductions with affordable price increases but we believe that NETS will do little if anything to address the first objective of energy security. Energy security in a carbon constrained economy relies on the rapid new deployment of low and zero emissions renewable energy capacity.

A coordinated national approach and a broad suite of policy initiatives is required to change Australia's energy sector from a high intensity to a low intensity producer while continuing to invest in new production capabilities to meet the increasing demand for energy. Pacific Hydro encourages all State Governments to increase and coordinate their commitments to renewable energy through the development of a National Renewable Energy Target of 20% by 2020.

Caps

The main risk associated with the implementation of a carbon trading scheme is that it is not ambitious enough and thus ineffective. Pacific Hydro believes that whilst the level of technical detail and contingencies accounted for in the *Discussion Paper* are laudable, any such scheme will be judged on two of the three objectives mentioned above: the absolute levels of emission abatement and the costs of this abatement. We believe the costs will be lower than general expectations and regulators should keep in mind that generation only represents 40% of end use energy costs. Therefore a 40% increase in generation costs only results in a 16% increase for the consumer.

ENCLOSURE

Experience from the European Emissions Trading Scheme (EU ETS) suggests that regardless of the details of the scheme, the only factors that will result in successful emissions abatement depend on three factors of the scheme: Caps; Targets; and Timeframes. We believe that for an Australian NETS to avoid the mistakes made in the EU ETS where a group of countries, including large polluters such as Germany, were left with 44.1 million tonnes extra CO₂ allowances for the year 2005¹, caps must be low, targets must be ambitious and timeframes must be short.

The NETS should aim to set the cap as low as possible in line with previously stated Government aims of a 60% reduction in greenhouse gas emissions on 2000 levels by 2050. Given that electricity demand is expected to increase by 21% by 2015², this target is suitably ambitious, and challenging and strong caps need to be set on commencement of the scheme to achieve it. The tighter the caps are in the first period, the lower will be the costs associated in future periods.

The level of cap proposed under scenario 2 in the *Discussion Paper* is expected to lead to a cost per tonne of CO₂ of \$35 over the life of the scheme. According to ABARE predictions the price of carbon should be between \$US 38 and \$US85 from 2010 onwards³. This leads us to believe that the cap levels proposed under scenario 2 is significantly too high. Given that the Taskforce has been at pains to design the scheme with the intent that it would be applicable with international schemes, the cap needs to be commiserate with international cap setting. The European Union has a target of 15-20% reduction in emissions below 1990 levels by 2020 and the Regional Greenhouse Initiative (RGGI) in the US has a target of 10% reduction in emissions below current levels by 2019, while some other US state has lower caps and more ambitious targets.

We support a cap on emissions targeted at 10% below 2000 levels by 2020 with rolling gateways every five years starting in 2010 at the latest.

Projected Carbon Prices

Pacific Hydro has significant investments in renewable energy in both Australia and overseas and have experience operating in countries that are both Annex 1 and Annex 2 Kyoto countries that are already participating in carbon trading through the EU ETS and we have several projects that are already producing saleable certificates under the Kyoto Clean Development Mechanism (CDM), most notably in Chile.

In Fiji, where Pacific Hydro is creating Certified Emissions Reductions (CER's), and the underlying energy price is \$A80, about 2.5 times Australian prices, the project only reached the hurdle rate when The EU carbon price of € 10 was included. Australia's low underlying electricity prices mean that significantly higher than current EU carbon prices would be required to see meaningful investments in renewable energy projects.

¹ Emissions trading: Commission sets out guidance on national allocations for 2008-2012

² 2006 Statement of opportunities, NEMMCO

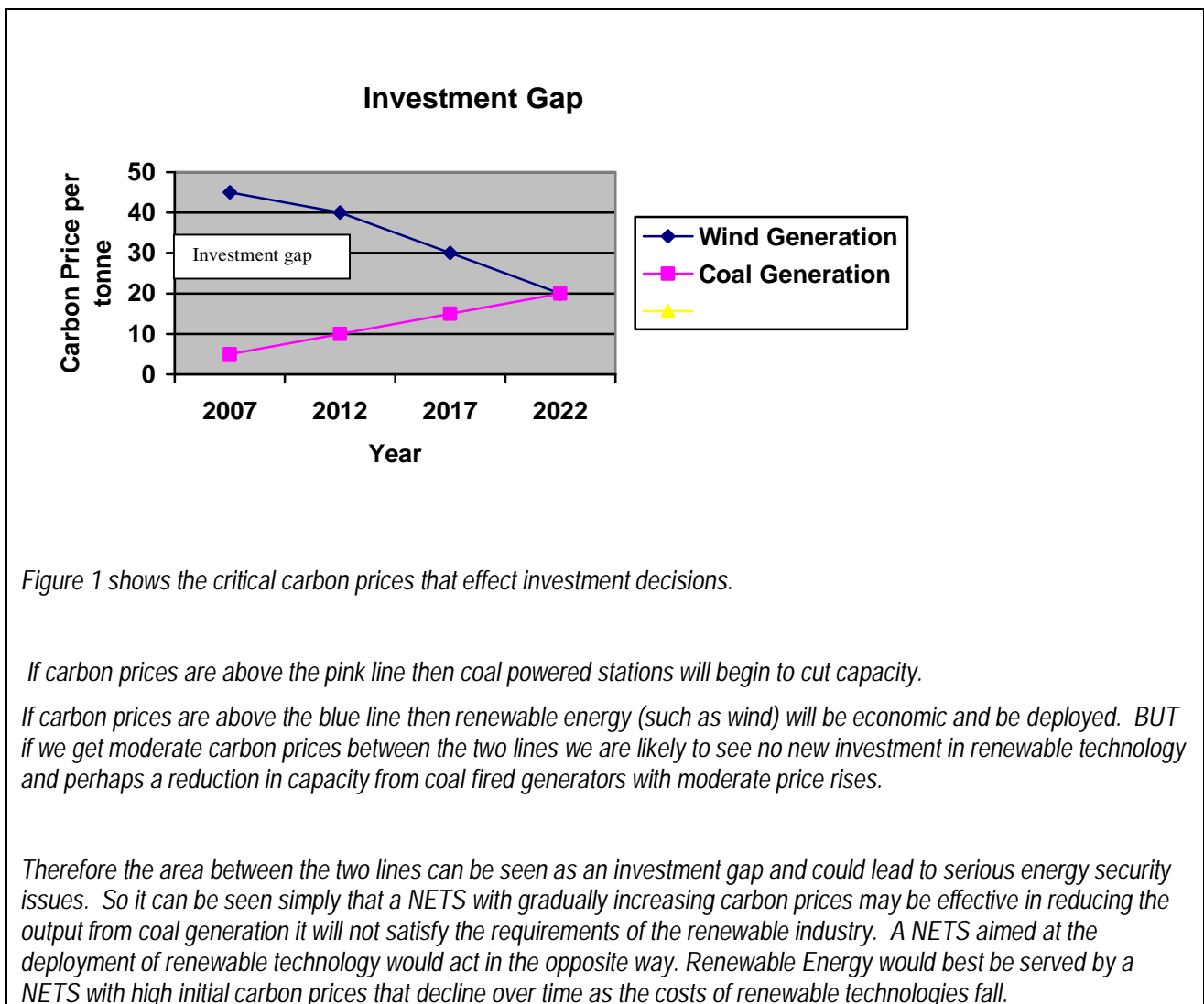
³ Climate change policies, integrating developing countries into the architecture of policies, Australian Bureau of Agricultural and Resource Economics, December 2006.

Pacific Hydro supports low initial cap setting

A cap and trade scheme runs the risk of delivering an investment gap and undermining the objective of energy security. This investment gap is likely to take place at a low price for carbon which make new investments in fossil fuel generation uneconomic but where the price is not high enough for viable deployment of renewable energy projects in the short term.

Assuming the moderate mandatory targets set for renewable energy generation purchases placed on retailers, the price of carbon will need to be above \$35 to avoid the investment gap and the resulting energy security issues (see diagram on the investment gap).

Figure 1. The Investment Gap



Pacific Hydro supports a National Renewable Energy target of 20% by 2020 to run in parallel with NETS.

Linking with international schemes

We believe that absolute targets are not as effective as intensity based targets (baseline and credit) in achieving the three objectives for the Australian energy sector of long term energy security, low or zero emissions and internationally competitive energy prices. However, as stated above, we recognise that designing a scheme that is complimentary to international schemes is very important and given that Kyoto has developed so comprehensively we support the Taskforce in developing a cap and trade model in Australia that would satisfy participation in a Kyoto style scheme.

The NETS should be compatible with international schemes

Although it is essential that the NETS is linked to international schemes, we believe that restrictive quotas should be placed on the import of international CDM's by Australian companies. When deciding on this quota, it is important to recognise that a trade-off exists between the competing objectives of energy security and cost abatement. Given that Australia is such a high emitter relative to the rest of the world, we would certainly be a net importer of carbon permits. A reasonable quota of 10% of tradeable permits from imports should provide a suitable mix of low cost abatement and incentives for investments in local low and zero emissions production capacity to meet future energy security demands.

We support an initial restrictive quota of 10% of tradeable permits to be sourced from imports⁴

Coverage and allocation

As stated above, we believe Intensity based or benchmarking is the preferred and economic orthodox approach to achieving a less carbon intensive energy sector capable satisfying the simultaneous objectives of increasing production capacity and reductions in emissions without making this a zero sum trade-off. The cap and trade scheme tends to reward existing fossil fuel generators for reducing capacity because of the associated reduction in emissions even if there has been no productivity improvement undertaken. In general we would like to support the principle that productivity improvements and reductions in energy intensity measured by CO₂ emissions per MWh are adopted as the key performance indicators for the energy sector.

Whilst we are loath to add unnecessary complications to the scheme we believe there is a strong case for adding a parallel benchmarking measurement similar to that under the NSW GGAS scheme. Even if benchmarking is not used as a formal part of a cap and trade mechanism, it will become increasingly more important to measure the performance of various sectors. Given our statements that the NETS should be viewed as a tool amongst a suite of policies aimed at providing the least cost shift towards a low or zero emissions energy sector, we support coverage of as many emitting sectors as possible as soon as possible. We do anticipate that the inclusion of many sectors will be troublesome in a dynamic economy as each sector debates how much of the burden it bears. Asking for a 50% absolute reduction in emissions from an energy sector that doubles in size is actually asking for a reduction of 75% in real terms. Because the relative size of sectors will change dynamically, it is important to provide some form of benchmarking so as regulators can make some sense of the actual performance and efficiency improvements made by various sectors.

⁴ We would expect this quota to be increased over time with the long term goal of free trade in CER's..

This can assist regulators setting targets during the gateway periods as well provide a useful countenance to potential squabbles amongst different sectors arguing over who should bear what costs.

We support a parallel benchmarking mechanism to measure emissions intensity.

Apart from the low caps and short timeframes already suggested in this submission, the other economically orthodox and market based mechanism to provide the correct price signals is to auction all of the available capped permits. We also identify a possible element of conflicting interest for governments that are beneficiaries of high auction prices for permit allocations but victims of higher prices in their role as owners of generators. Thus a conflict could emerge between states depending on the net benefit expected from such an auction.

We support auctioning 100% of available permits.

Assistance for adversely affected parties

We accept the political reality of assistance for trade exposed industry, however we believe that the scheme's integrity would be better served if this assistance was in the form of year-end rebates rather than free allocations. This would enable the scheme to assess true costs of emissions and then use funds to transfer to those that qualify for assistance outside of the scheme. This would provide greater integrity to the scheme. We also support some revenues from the scheme being available for low income and disadvantaged consumers affected by rising electricity prices under existing hardship programs.

Pacific Hydro would welcome the opportunity to be consulted on the development of the scheme moving forward in 2007.

Yours faithfully



Rob Grant
Chief Executive Officer

For further information please contact:

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Pacific Hydro is Australia's leading renewable energy company, privately owned by 3 million superannuates through Industry Super Funds.