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SUBMISSION TO THE SENATE STANDING COMMITTEE ON ECONOMICS: INQUIRY INTO THE CLEAN ENERGY AMENDMENT BILLS 2012

Established in late 2005, The Climate Institute is a non-partisan, independent research organisation that works with community, business and government to catalyse and drive the change and innovation needed for a low pollution economy and culture.

Our vision is for a resilient Australia prospering in a zero carbon global economy, participating fully and fairly in international climate change solutions.

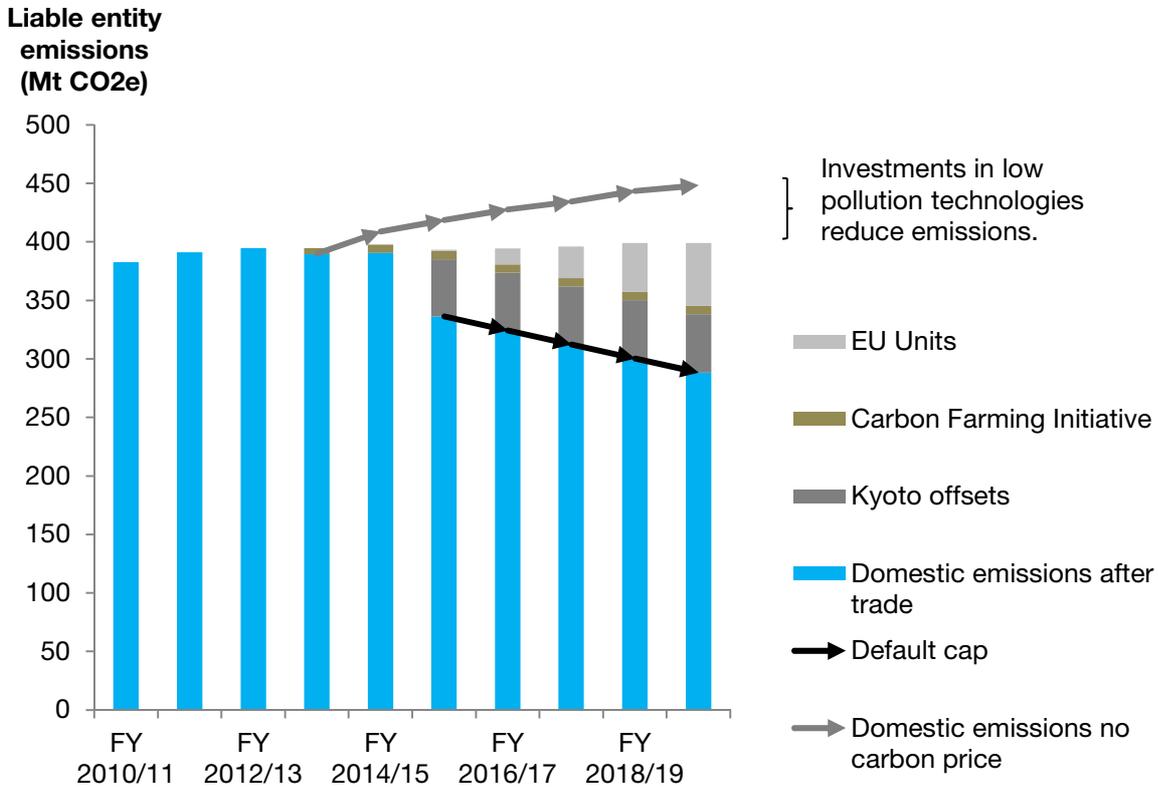
The Climate Institute welcomes the opportunity to present its views to the House Standing Committee on Economics Inquiry into the Clean Energy Amendment Bills 2012.

Introduction

Australia's carbon laws are designed to do two things: reduce pollution to levels consistent with avoiding dangerous climate change and drive low pollution investment in Australia. With this in mind The Climate Institute cautiously welcomed the announcement by the Government to join Australia's emission trading scheme to the European Union's.

The first broad point to make is that recent discussions around Australia's carbon laws have largely focused on the carbon price (or carbon 'tax'). The laws are more than this. Specifically, they include the setting of flexible caps that will limit the amount of carbon emissions Australia contributes to climate change (Figure 1).

Figure 1: More than a price. In 2015, for first time, Australia's largest emitters will face an absolute limit on pollution. To comply with this cap emitters will invest in emission reduction and/or buy Carbon Farming Initiative, Kyoto and EU emission units.



Secondly, as we have argued alongside other policy experts¹, the Institute's preference is for an extended price floor because of the predictability it provides investors and the economic efficiencies it could deliver.

The signal sent by a gradually rising price floor has three beneficial effects:

1. it helps deter investment in highly emission intensive technologies that would become stranded under the stronger policies needed in the future.
2. it reduces downside financial risk premiums associated with low carbon investments thereby reducing the costs of investments.
3. it encourages investment in low emissions technologies through more predictable price signals. This brings down their costs through 'learning by doing' and economies of scale.

Among others, these are the reasons why the UK and California have implemented price floors and why China is considering floors in its emerging pilot schemes.

As an alternative, linking with the world's biggest carbon market with a limit on international permits is welcome so long as it is combined with strong policies for domestic clean energy and energy efficiency.

Credible carbon laws are critical to economic prosperity

Credible carbon laws are needed to unlock investment in clean energy, drive domestic emissions down, and build political support for market-based mechanisms.

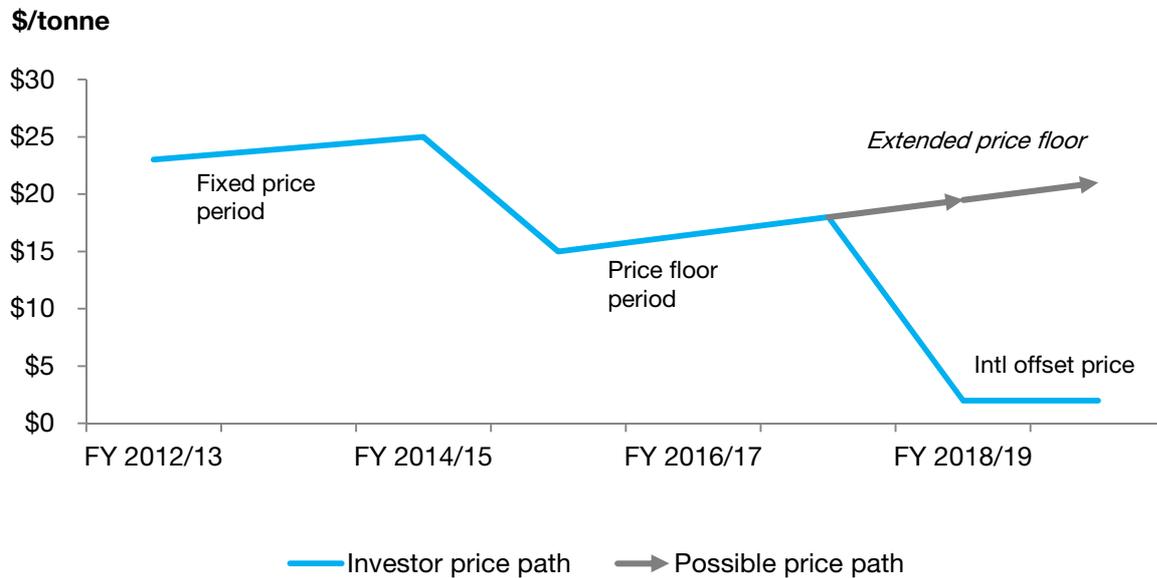
Much of the recent political debate in Australia has portrayed our carbon laws as more ambitious than those in other economies. For example, the Business Council of Australia has stated that firms in Australia are paying the world's highest carbon price. Similarly, many voices called for the abolition of the \$23 fixed price or the \$15 price floor on the basis that these would impose an uncommonly high carbon price. These arguments are not supported by evidence. Many large, advanced economies have higher carbon prices as well as more ambitious complementary policies than Australia.²

Also, Australia was unusual in that no other major economy had coupled its future domestic carbon price to the international offset market. The EU has strong limits on international offsets, while California and South Korea appear likely to ban them all together until at least 2020. These countries are seeking to shift their domestic economies to low carbon foundations while at the same time supporting global solutions.

Without a carbon price floor or strong limits on the import of international offset credits from developing countries, Australian carbon prices would likely fall to single digits in 2015. An Australian company then could buy a credit from a country like China for a renewable energy project that they had built for less than \$5/tonne (Figure 1).

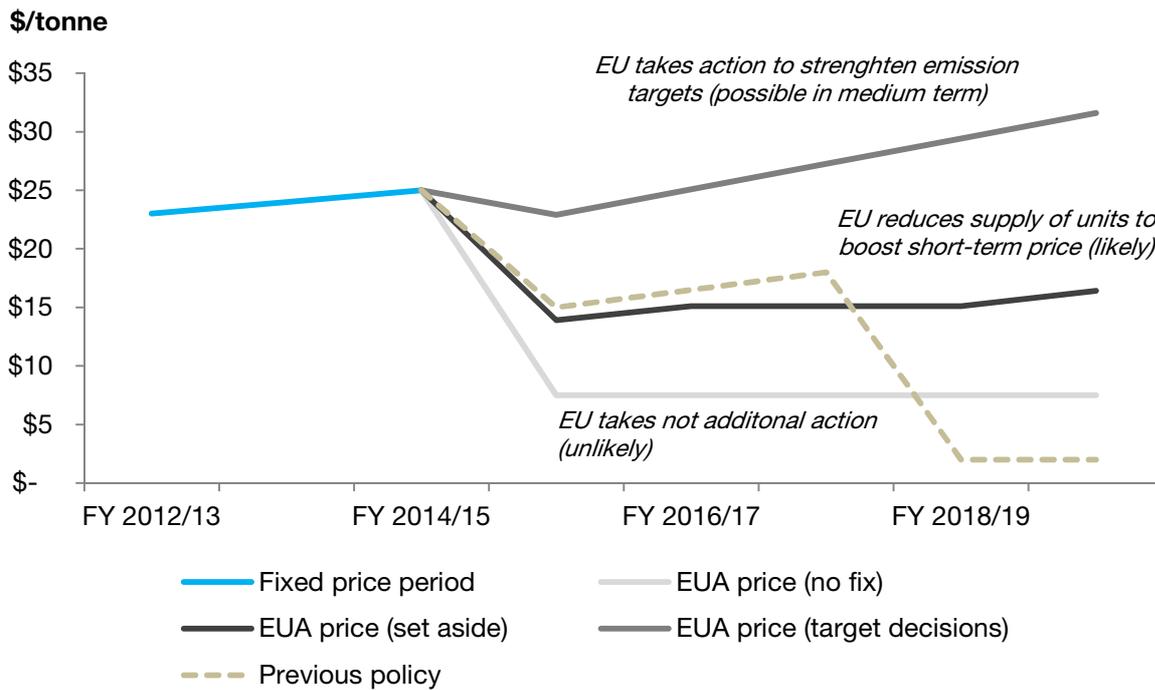
While this might appear attractive in the short term, a single-digit carbon price risks locking Australia into the polluting technology of the past and does not prepare the country for the emerging and inevitable low-carbon economy.

Figure 2: Illustrative price paths under previous policy. The ‘investor price path’ was how many in the investment community considered the previous policy’s price trajectory. After the end of the price floor in 2018, they saw Australia’s price falling to that of the international carbon offset market. However, the Climate Change Authority was to review the price floor in 2016 which could have led to its extension.



Linking with the EU’s carbon laws and limiting the use of carbon credits from developing countries should help to ensure Australia’s carbon laws do not become a toothless tiger in 2015. Based on current forecasts and assuming that the EU’s efforts to increase its carbon prices succeed, Australian companies could be paying roughly the same as European companies of around \$15-\$20/tonne in 2015 (Figure 2). With more ambitious action in the EU analysts have forecast that the price could be on track to reach up to \$30/tonne by 2020.

Figure 3: Illustrative price paths under new policy. Under the new policy Australia's carbon price will interact with the EU carbon price. Investors will now consider the actions of EU policy makers in considering investments in Australia. This figure illustrates, based on Deutsche Bank forecasts, a range of possible carbon prices in Australia based on the interaction between Australian and EU carbon markets. The different grey lines indicate different levels of market intervention currently being considered in the EU. This is illustrative only. Market forecasts are by their nature very uncertain. For example, this does not include the price impact of demand from Australian companies for EU units.



Note that the EU price has been over \$30 in the last three years. Current forecasts are uncertain and cover a wide range of opinion and assumptions. What can be predicted with confidence is that based on the proposed linkage and limits, Australian carbon prices in 2020 will likely be substantially higher than the recent forecasts of \$2-\$5/tonne. This fundamentally changes the way firms will look at their investments over the next few years.

Ensuring policies reflect long-term benefits

While the carbon laws are an important achievement, current carbon prices still do not reflect the long-term benefits associated with reducing emissions and driving investment in clean energy today. This is why additional policies such as the Renewable Energy Target, the proposed national Energy Savings Initiative and emission performance standards such as those being implemented in other major economies are required to ensure transformation of Australia's high carbon economy. These policies, combined with the carbon price, ensure a more optimal and early level of investment in clean energy and carbon solutions than a carbon price by itself.

Overall, complementary policies have an essential role to play in the transition to a zero emissions economy. This transition is a marathon, not a sprint. Success requires setting policy that provides incentives for Australian firms to start investing in way consistent with long-term goals.

In the absence of policies consistent with avoiding dangerous climate change business will delay the required investments in low-carbon technologies and carbon sequestration. The longer the delay in low-carbon investments the higher the economic costs of meeting longer term emission targets, for example, as investors commit to long-term assets that are excessively emissions-intensive. As a result, the nation risks deadweight losses from 'stranded assets' and will have to spend on more costly abatement later on.

Finally, while many elements of a technology's costs will be determined by global factors, domestic learning by doing has and will continue as new technologies are adopted. This will reduce the long-term costs of emission reductions.

Once global carbon markets are more developed the advantages of complementary measures might be outweighed by emerging domestic and international considerations. However, this is unlikely to occur before 2020.

Building global momentum

The linking arrangements between Australia and the EU will strongly influence similar agreements with other emission trading markets. Any bilateral deal between nation states to link their emissions trading scheme carries the risk of building a fragmented global market. Such arrangements should be undertaken in a way that does not undermine progress towards multilateral cooperation and build global emission reduction ambition.³

Australia has an opportunity to build global momentum both through linking with the EU and taking on a new commitment under the Kyoto Protocol. These processes can be mutually reinforcing. As a nation very vulnerable to the impacts of climate change, it is in Australia's national interest to accept a new Kyoto Protocol target to support an ambitious international agreement that covers all major emitters.

Moreover, as the EU is committed in principle to a second Kyoto target, Australia's approach to its own Kyoto target may affect the treaty negotiations over emission trading scheme linkage. The political dynamics of the mandate that member states give the European Commission (EC) could be coloured by Australia's posture with regard to the Kyoto Protocol. This has become more likely now that the EC is expected to seek a mandate to negotiate a treaty after the next meeting of the Kyoto Protocol later this year.

Australia should join the EU, Norway, Switzerland, the Ukraine and other former Soviet countries in taking on a new commitment under the Kyoto Protocol.

Holding back a new Kyoto commitment, or using delay as a negotiating tactic does not help create momentum towards coordinated global action to avoid dangerous climate change.

If Australia does not take on a new Kyoto target there is also a risk that Australian companies will not be able to directly access emission units generated under the UN's international trading mechanisms.⁴ For business this creates one or more of the following risks:

- Greater levels of uncertainty as to when, how and at what price companies could access international units as protracted negotiations around the eligibility of countries to access markets continue.

- No direct access to emission units generated under the UN's international trading mechanisms due to Australia being defined ineligible. This would increase the effective carbon prices paid by business in Australia.

Governance

The Climate Institute's initial queries around Amendments to the Clean Energy Act were around the broad discretion of the Minister under Section 123A 'Designated limit'. However, proposed amendments which include that the Minister 'must' consider the reports of the Climate Change Authority in setting designated limits go some way to alleviate these concerns. The Institute would still propose that the following 'must' be considered when setting limits on international imports:

- the environmental integrity of this Act and the associated provisions
- Australia's international obligations under international climate change agreements.

Conclusions

Linking with the world's biggest carbon market with a limit on international permits is an important policy development. However, to ensure that Australia builds cost-effective domestic and international climate change action the linkage needs to be complemented by:

1. **Strong policies for clean energy and energy efficiency:** Critically, no major changes should be made to bipartisan supported Renewable Energy Target (RET).⁵ Any major changes to the RET threatens investment in clean energy in Australia. It also would increase the cost of energy sector investment broadly by increasing investment risk premiums.

A national Energy Savings Initiative⁶, such as that being currently investigated by the Commonwealth in consultation with the States, should also be a priority to manage rising energy costs and build a 'long, loud and legal' framework for large scale investment in energy efficiency.

Given the failure of 'contracts of closure' talks between the Government and the brown coal generators and the major expansion of the coal seam gas industry⁷, providing clearer direction to investors and state governments on the future of fossil fuel power generation is more urgent than ever before. The opportunity to set in place emission standards and technology requirements for new fossil fuel power stations⁸ can act as an insurance policy to avoid the construction of new power plants that could undermine national climate change mitigation goals and/or lead to stranded assets and higher costs in future.

2. **Taking on a second commitment under the Kyoto Protocol:** In the absence of a new Kyoto commitment the Government cannot currently guarantee business direct access to international units under this Treaty.
3. **Making minor amendments to improve governance:** The Bills should be change to ensure the Minister 'must' consider the environmental integrity of this Act and Australia's international obligations under international climate change agreements when setting designated limits.

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¹ Frank Jotzo, Erwin Jackson, Tony Wood and Cameron Hepburn, Carbon price floor crucial to its aims, *Australian Financial Review*, 5 July, 2012 <<http://ccep.anu.edu.au/data/2012/pdf/news/20120705-carbon-price-floor-joint-oped.pdf>>.

² The Climate Institute, Snapshot of country climate change action, The Climate Institute, Sydney: June 2012 <http://www.climateinstitute.org.au/verve/_resources/TCI_GlobalClimateAndCleanEnergyAction_MediaBrief_26June2012_file.pdf>.

³ Salim Mazouz and Erwin Jackson, *Emissions Trading Coalitions – Leveraging Emissions Trading to Achieve Greater Levels of Global Mitigation Ambition*, Discussion paper, The Climate Institute, Sydney: February 2012 <http://www.climateinstitute.org.au/verve/_resources/tci_regionalemissionstradingcoalitions_discussionpaper_mar2012.pdf>.

⁴ The Climate Institute, *The Kyoto Protocol: Impact on International Carbon Market Access for Australian Business*, Policy Brief, Sydney: August 2012 <http://www.climateinstitute.org.au/verve/_resources/TCI_PolicyBrief_CDMandKP_August2012.pdf>.

⁵ The Climate Institute, *Climate Change Authority Review of the Renewable Energy Target*, Submission, The Climate Institute, Sydney: September 2012 <http://www.climateinstitute.org.au/verve/_resources/TCI_RETReview_ClimateChangeAuthority_Submission_19September2012_web.pdf>.

⁶ The Climate Institute, *The National Energy Savings Initiative*, The Climate Institute, Sydney: August 2012 <http://www.climateinstitute.org.au/verve/_resources/TCI_NationalEnergySavingsInitiative_MediaBrief_8August2012.pdf>.

⁷ Olivia Kember, *Coal Seam Gas Emissions: Facts, Challenges and Questions*, Discussion paper, The Climate Institute, Sydney: 2012 <http://www.climateinstitute.org.au/verve/_resources/TCI_CSG_DiscussionPaper_September2012.pdf>.

⁸ WWF and The Climate Institute, *Regarding: 'A Clean Future for Power Stations' Discussion Paper*, Submission, WWF/The Climate Institute, Sydney: December 2010 <http://www.climateinstitute.org.au/verve/_resources/wwftci_emissionstandardssubmission_dec2010.pdf>.