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Select Committee on the Scrutiny of New Taxes
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Inquiry into carbon pricing mechanisms

The Energy Supply Association of Australia (esaa) welcomes the opportunity to make a submission to the Senate Select Committee on Scrutiny of New Taxes Inquiry into Carbon Tax Pricing Mechanisms.

esaa made a submission in May 2011 to the Committee prior to the release of the Clean Energy Future policy documents and the release of the exposure draft of the *Clean Energy Bill 2011* and related bills. The release of further detail around the Government's carbon pricing mechanism provides an opportunity for the Association to elaborate further on its policy position with respect to the Clean Energy Future package.

esaa is the peak industry body for the stationary energy sector in Australia and represents the policy positions of the Chief Executives of over 40 electricity and downstream natural gas businesses. These businesses own and operate some $120 billion in assets, employ over 52,000 people and contribute $16 billion directly to the nation's Gross Domestic Product each year.

Executive summary

The Association supports the development and implementation of a well-designed ETS. Despite some welcome improvements in the *Clean Energy Bill 2011* compared to the architecture document released on 24 February 2011 by the Multi-Party Committee on Climate Change, esaa considers there remain serious deficiencies with the scheme. This submission outlines the industry's five key concerns with the scheme, which require the Government to:

1. Adequately address the stranding of coal-fired generation assets. A more measured transition to full auctioning of carbon units (as proposed in most other schemes around the world to date) would enable a greater volume of carbon units to be administratively allocated to affected generators to ensure there is no disproportionate loss of economic value on the sector's balance

sheets or a rise in costs to such a level as to compromise both the ability to refinance, and/or re-invest in existing power plant;

2. Ensure there are no additional working capital requirements for liable entities from the operation of the *Clean Energy Bill 2011*, including from taxation and auctioning;

3. Provide longer term certainty to the sector by committing to ten years of rolling scheme caps followed by a ten-year rolling gateway. This is necessary to support the development of the emissions market in Australia and because global emissions prices do not provide sufficient long term information in isolation;

4. Cover the greatest proportion of greenhouse gas emissions possible. Measures that only target a subset of sectors of the Australian economy are unlikely to lead to least cost abatement; and

5. Ensure retail price regulation is removed for electricity and gas. Efficient prices are necessary to provide the appropriate signals for consumption and new investment and without full cost pass-through the viability of retailers and the entire electricity and gas supply industry is at risk.

The submission also addresses a number of new issues that emerged in the legislation that were not identified in the Clean Energy Future policy document, as well as providing direct comment and feedback on the drafting of the legislation. Issues discussed include:

- the carbon pollution cap, including developing a more appropriate default trajectory and developing regulations setting the cap as soon as possible, rather than by May 2014;

- the mechanics of liable entities, including clarifying a range of issues with respect to gas liability and increasing the flexibility of the joint venture provisions;

- the treatment of coal‑fired electricity generation, including providing greater certainty on how the Energy Security Fund, the Power System Reliability Test and the Clean Energy Investment Plans are to be implemented;

- auction design, including consultation on developing the details of auctions and clarifying that auctions will not be cleared on a pay-as-bid basis;

- the international unit surrender charge, including its detrimental impact on the development of international abatement markets and scheme participants and discussing options for implementation to minimise its effect;

- information-gathering powers and monitoring powers, including that powers should be contained to circumstances where the Regulator has a reasonable belief that breach or non-compliance has occurred;

- taxation, including clarity on the treatment of deductions, the same business test and the non-levying of stamp duty on the transfer of emissions units;

- unit shortfall charge, including that the proposed non-deductible charge of 200% of the benchmark average auction price is overly onerous; and

- governance arrangements, including calling for details on how the Energy Security Council will operate and for further detail to help industry understand the impact of the Clean Energy Finance Corporation CEFC on electricity markets.

esaa notes that there is still a considerable amount of detail to be included in legislative instruments. Consultation on these issues needs to begin as soon as possible in order to ensure high quality results.

Introduction

The energy industry currently produces over 37 per cent of Australia's greenhouse gas emissions and will be significantly impacted by the introduction of a new charge on greenhouse gas emissions. As Australia's largest source of emissions, the energy industry has engaged keenly in the national conversation on greenhouse policy.

Many aspects of the policy were presented for the first time on 10 July 2011 and no opportunity was given for formal consultation. The legislative package released on 28 July 2011 also contained further new details. This contrasts with the development of the Carbon Pollution Reduction Scheme (CPRS), which involved a full Green and White Paper process.

esaa considers that the implementation of a well-designed national emissions trading scheme (ETS) is a critical measure for ensuring investor confidence in the energy sector. A well-designed ETS must be efficient, effective and equitable in the long term and, importantly, must ensure a smooth and orderly economic transition in the short-to-medium term. Failure to ensure an orderly transition could have widespread and potentially long lasting adverse economic impacts.

As a small, open economy, with a relatively high cost of abatement, an Australian ETS will be highly influenced by developments in international greenhouse policy. Since the development of the CPRS, the international environment has changed. The Kyoto Protocol expires after 2012 and there is no binding global agreement to limit emissions in place to succeed it. This clouds the outlook for international abatement and future linkages with overseas carbon markets, which in turn underscores the importance of a well-designed Australian ETS that maximises flexibility and efficiency and enables Australia to achieve its emissions reduction goals at least cost.

There are some welcome improvements in the *Clean Energy Bill 2011* compared to the architecture document released on 24 February 2011 by the Multi-Party Committee on Climate Change, such as the commitment to a preset limit on the fixed price period and the change of the point of liability to reflect operational control. These changes demonstrate the importance of consultation between Government and affected parties and will contribute to the effectiveness and efficiency of the scheme.

Notwithstanding these improvements, esaa considers that there remain serious deficiencies with the scheme. Not only do the Association's four primary concerns with the CPRS essentially still hold, but the industry is also concerned by the reduction in coverage of the scheme.

This submission firstly outlines these five critical issues. It then addresses a number of new issues that emerged in the legislation that were not identified in the Clean Energy Future policy document, as well as providing direct comment on the drafting of the legislation.

The industry's five critical issues with the Clean Energy Future package

esaa supports the development and implementation of a well designed ETS. The industry's five critical issues that need resolving in order to ensure the security of supply and investor confidence in long-lived, capital-intensive assets, require the Government to:

1. Adequately address the stranding of coal-fired generation assets. A more measured transition to full auctioning of carbon units (as proposed in most other schemes around the world to date) would enable a greater volume of carbon units to be administratively allocated to affected generators to ensure there is no disproportionate loss of economic value on the sector's balance sheets or a rise in costs to such a level as to compromise both the ability to refinance, and/or re-invest in existing power plant. In addition, the cash payment of $1 billion for 2011-12 referred to in the policy announcements is not identified in the legislation, which does not provide certainty to industry;

2. Ensure there are no additional working capital requirements for liable entities from the operation of the *Clean Energy Bill 2011*, including from taxation and auctioning. Further, the legislation is silent on the provision of the financial facilities by Government that are ostensibly meant to address working capital issues;

3. Provide longer term certainty to the sector by committing to ten years of rolling scheme caps followed by a ten-year rolling gateway. This is necessary to support the development of the emissions market in Australia and because global emissions prices do not provide sufficient long term information in isolation;

4. Cover the greatest proportion of greenhouse gas emissions possible. Measures that only target a subset of sectors of the Australian economy are unlikely to lead to least cost abatement; and

5. Ensure retail price regulation is removed for electricity and gas. Efficient prices are necessary to provide the appropriate signals for consumption and new investment and without full cost pass-through the viability of retailers and the entire electricity and gas supply industry is at risk.

1. Adequate assistance to industry

Energy Security Fund

The Energy Security Fund provides around $5.5 billion in nominal, pre-tax terms to affected generators over a six year period. Additionally, the Government may negotiate for the closure of around 2000 megawatts (MW) of highly emission-intensive (>1.2tCO_2-e/MWh) coal fired generation capacity by 2020.

This sum does not adequately address the impairment of asset values across the electricity sector. It provides virtually nothing for the black coal fired generation community – both state government and privately owned. The Association's analysis suggests that just 8 or 9 out of the 31 baseload coal plants that provide the energy security the community takes for granted will receive assistance. Even fewer will be eligible for closure payments. This could only be rectified by increasing the quantum of assistance rather than reweighting the distribution of the existing assistance. The Association urges the Government to increase the quantum of the assistance and to broaden the eligibility criteria to address the impacts on existing investments and minimise the costs of future energy requirements.

Government modelling during the CPRS found that over the first 10 years black coal-fired generators would suffer asset value losses of $5 billion to $6 billion (real 2008-09 dollars). The latest Treasury modelling does not give the industry confidence that the outcome would be substantially different under the Clean Energy Future package. In fact, while the Treasury's *Strong Growth, Low Pollution: Modelling a Carbon Price* report makes reference to SKM-MMA and ROAM Consulting's results showing reduced profitability of coal-fired generators, the consultants' reports themselves do not contain any of this information. The Association has called on the Government to release the details underpinning the estimates for the reduction in profitability of coal-fired generators as soon as possible. Figures presented for losses in profitability under the CPRS and Clean Energy Future scheme only cover the first ten years of the scheme, while the profitability of generators will continue to decline beyond this period as the carbon price increases and generators are prematurely retired.

Asset value losses will require government owners to inject further equity to their companies while for the private sector, in addition to the likely equity call, refinancing will be made very difficult as their commercial fundamentals are challenged. These issues are explored in detail in the Investment Reference Group report to the Minister for Resources and Energy. As a last resort, the Government is offering loans for replacement debt and working capital, but at rates above the commercial market and subject to as yet undisclosed terms. esaa also notes that the legislation is silent on the provision of these financial facilities by Government.

Given the multi-billion dollar extent of impairment to assets from carbon pricing, transitional arrangements fail to fully address asset value loss and are certainly not the rent seeking and 'payment to polluters' that some would lead the community to believe they represent.

The Government has commissioned or requested multiple reports examining the impacts of emissions pricing on the energy sector. These have consistently warned of the potentially negative effects. The Energy Security Fund is not an adequate response to the material risks to the electricity market outlined in these reports.

The Chairman of the Australian Energy Market Commission (AEMC), John Pierce, advised the Government on 7 July 2011 in a letter addressed to the Hon Greg Combet AM MP and the Hon Martin Ferguson AM MP, that the carbon pricing package can be expected to result in "some but not all, of the generation businesses with high emission intensive plant to facing [sic] a degree of financial impairment that would place them under severe financial distress"[1].

The Investment Reference Group (IRG) has also advocated for transitional assistance which preserved "sufficient net equity in the business to maintain its capacity to participate in the electricity contract market and undertake or contribute to the desired investment and reinvestment task"[2]. This issue of the impact of asset value impairment from carbon pricing on the electricity contract market has been raised by industry throughout the greenhouse debate and identified in a number of Government reports in addition to the IRG report recently.[3] However, the exposition of this issue has been qualitative to date. esaa is currently undertaking a modelling exercise to quantitatively examine the possible impacts of reduced contracting resulting from issues such as financial stress on generators, on wholesale, contract and retail prices and will provide its results to Government in due course.

In its advice to the Ministerial Council on Energy on the Garnaut Update, the AEMC argued that "granting permits in respect of specific plant would [allow plant owners] to maintain sufficient net equity in the generation businesses for them to be in a position to invest in the future"[4]. Reorienting five decades of investment in primarily coal-based generation to a lower emissions footing presents the Australian electricity industry with a massive investment task. The Treasury modelling estimates $23-27 billion in generation investment is required by 2020 and more than $200 billion to 2050. Other estimates put the investment challenge as high as $220 billion to 2030, when networks are also included.[5] To achieve such a large investment task Australia will need to attract overseas debt and equity as well as domestic investment. It will have to do so under the context of a price on carbon.

Australia must consequently take steps to ensure it presents as an attractive destination if it is to raise this capital in the volumes required and at the lowest possible cost. In direct contrast to this imperative, diminishing equity investments

[1] http://www.ret.gov.au/energy/Documents/Energy-Security/energy-security-fund/AEMC_07_07_2011.pdf
[2] Investment Reference Group, *A Report to the Commonwealth Minister for Resources and Energy*, April 2011
[3] See for instance, the AEMC Advice for MCE on Garnaut Paper, the Electricity Generation Investment Analysis report by Deloitte; the AEMC's advice to the Minister for Resources, Energy and Tourism and the Minister for Climate Change and Energy Efficiency.
[4] AEMC Advice for MCE on Garnaut Paper, 2 June 2011
[5] Australia's Energy Future, 4 May 2011, Speech to the Committee for the Economic Development of Australia.

through a disorderly transition will send a profound and damaging signal to the international investor community about Australia's sovereign risk and raise the risks of doing business in its energy sector. This will have consequences in less capital being available, and if it is, at higher debt/equity risk premiums, which will add to the cost of energy supplied to the community.[6]

The *Clean Energy Bill 2011*, contains no reference to the cash payment of $1 billion for 2011-12 referred to in the policy announcement and commentary to the bill. In particular, the Government's policy announcement states that allocation of the cash payment under the Energy Security Fund is to be "based on the extent to which each generator's emissions intensity exceeds 0.86 tCO_2-e/MWh 'as generated' multiplied by their historical energy output, calculated over the period 2008-09 and 2009-10".

esaa is concerned by the absence of any reference to this portion of assistance. To provide certainty and confidence to industry about this cash component and the way it will be allocated, these matters should be identified in the bill. In addition, provision should be made in the bill that, should the $1 billion not be allocated as currently proposed, an allocation of Australian carbon units of equivalent value will be made (including an adjustment for the time value of money). Such a provision would operate like the provision for default emissions caps, serving as a 'back stop' to decision-making processes outside of the legislation.

While there is some detail in the Clean Energy Future policy documents, the legislation does not specify the arrangements under which the price for administratively allocated units sold back to the Government during the fixed price period will be determined. More generally, the absence of sufficient detail around Energy Security Fund terms means the legislation should either clarify these or defer liability until clarity is provided to enable companies to remain a 'going concern' under the Corporations Act.

The taxation treatment of this $1 billion will result in a partial claw back through the taxation system of the ostensible value of the assistance publicised by the Government. The industry also notes that the proposed taxation arrangements for administratively allocated emissions units also results in the assistance being partially clawed back by Government through the tax system. This compounds the insufficiency of the assistance package to impaired generators and undermines the stated purpose in the bill of administratively allocated units, which is to "help generators that face sizeable losses in the value of their assets and support investor confidence." The industry therefore considers that as the imposition of a tax will reduce the level of compensation, it should be factored into the setting of the overall quantum of assistance.

[6] As demonstrated by Simshauser & Nelson (2011) in their paper *"Carbon taxes, toxic debt and second-round effects of zero compensation: the power generation meltdown scenario",* it will be the Australian community that bears the costs of poorly conceived policies for the energy sector through higher equity risk premiums, which will add to the cost of energy supplied to the community.

Contracts for closure

The concept of contract for closure is supported by esaa, however, more information is required around how the mechanism will work, what effect it will have on any assistance already received by affected generators under Part 8 of the *Clean Energy Bill 2011* and what conditions applicants will have to comply with in order to receive assistance.

Energy Security Council

The Government has proposed establishing an Energy Security Council (ESC) to advise it on systemic risks to energy security arising from the financial impairment of any market participants and measures to address these risks. Eligibility for assistance to address any systemic risks would be assessed on a case-by-case basis.

The NEM has not needed an ESC since its inception in 1998; competition and reliability of supply has thrived. The formation of an ESC suggests that the current policy settings are too harsh and not conducive to attaining a smooth transition.

The ESC and any initiatives it recommends would inevitably require extra bureaucratic structures and processes that amount to unwarranted interventions in an otherwise efficient market structure. They would also increase risk in the electricity market as the actions of the ESC simply add to the potential for undisciplined interventions by government. The directors of these businesses are obliged by law to respond to the known financial position at the time, and cannot rely on the uncertain responses of the ESC. Thus, as any measures deployed following the advice of the ESC are *ex post*, by the time any assistance is provided, the damage will already have been done. Fully recognising asset value impact and adjusting for it up-front would obviate the need for an additional, distortionary mechanism like the ESC.

2. Auction design and working capital burden

esaa has previously engaged closely with the Government on the need to design auctions appropriately. The Association considers that designing auctions with the needs of the energy sector in mind is reasonable as the stationary energy sector is likely to require a significant proportion of units sold at auction. The stationary energy sector's large share of the carbon units auctioned reflects: the restricted coverage of the carbon pricing mechanism (around 60 per cent of Australia's emissions); the large share of energy sector emissions in the covered sectors; and the fact that other covered sectors will receive significant administrative allocations through the Jobs and Competitiveness Program.

As carbon units will be a significant cost in energy production, the energy industry will need to secure prices for emission units before it can commit to sell electricity or gas – both in the current year and in future years under forward contracts.[7] This means

[7] The forward electricity contracting market is an integral part of Australia's electricity market and is, among other things, an essential element in ensuring sufficient investment in new generation capacity to deliver reliable electricity supplies to consumers. Gas contracts are also managed in a similar manner.

that to support the energy contracting market the carbon pricing mechanism must enable liable entities to form, with reasonable confidence, a view of the price of emissions a number of years into the future. To achieve this, it is necessary to ensure that sufficient volumes are available in advance of each compliance year to support contracting.

In this context, the Association supports the provision in the legislation for auctioning of units for future vintages. However, it does not support the prescription in the legislation of a limit on the auction of future vintage units. esaa notes the Government's desire to retain flexibility in setting caps. However, the specified limit (which only comes into effect when there are no regulations in place setting the pollution cap) of 15 million units in the first six months of the year before the regulation is set and 15 million units a year in earlier years, is unnecessary. It is also low given the size of the energy sector's emissions (around 200 Mt per annum) and the established practice of contracting a number of years in advance. For instance, during the CPRS process the industry considered possible schedules of permit releases and arrived at a view that forward-auctioning around 50 per cent of each vintage would be necessary to support forward electricity contracting practices. esaa suggests that the upfront restriction of 15 Mt be removed from the legislation, and the volumes of future vintages auctioned instead be determined in consultation with industry during the establishment of the policies, procedures and rules for auction carbon units.

As esaa has also communicated to the Government at great length, auctions should be designed to eliminate any increases in the working capital burden that a carbon price imposes on the energy sector. There are several measures which could alleviate this burden – such as deferred settlement arrangements – which have not been incorporated into the Clean Energy Future package.

As set out in the IRG report, generators will need to hold positions well in excess of $10 billion – more than $4 billion worth of units to comply with current year obligations, and positions on more than $6 billion worth of units to support forward electricity contracting.[8] Unless there are appropriate settlement arrangements, the cost of holding these positions will significantly increase working capital requirements, exacerbate costs to meet prudential requirements and ultimately make prices for consumers higher than they need to be. Appropriate settlement arrangements are therefore essential to enable liable entities to manage working capital requirements, ensure participation at auctions and deliver liquidity to electricity contracting markets. As noted above, esaa is undertaking modelling to examine the impact of reduced contracting on the electricity market.

To minimise compliance costs it is necessary to devise auction arrangements that:

- allow liable entities to secure a price for their carbon units consistent with forward contracting practices;

- without requiring liable entities to settle on (or take receipt of) those carbon units until after they have received revenue for electricity sales;

- while being consistent with preserving the integrity of the carbon pricing mechanism.

The industry's preferred option to meet these objectives is delayed settlement arrangements. These arrangements would provide the option for the bidder and the auction authority to strike a contract to purchase at the outcome of the auction. Under this arrangement there would be no delivery of permit or settlement of funds at the time of auction. Rather, the receipt of the permit and settlement would be delayed until a specified later date when the participant has had an opportunity to earn revenues from the activity that gives rise to the emissions associated with that permit but before the due date for submission of carbon units for the relevant compliance year.

This arrangement would not increase working capital costs for businesses and hence it would relieve upward pressure on electricity prices. It would also support auction liquidity and hence encourage efficient price discovery as all parties with genuine intent to purchase and settle carbon units could participate, without capital constraints. However, as purchasers would not receive the carbon units until they paid for them, the contract-to-purchase would not be a provision of credit from the Government to industry; rather it would just allow the industry to cement its emissions costs to support its future contracting and manage cash flows. On this matter, the Association notes that the Government's proposed loans to emissions-intensive generators to support future vintage unit purchases at auction will be priced at rates designed to encourage private sector finance. Far from reducing working capital costs, such a measure will add to them and ultimately increase prices for electricity consumers.

It is imperative the Government work with industry to develop arrangements which allow auction participants the option to receive and settle carbon units after they have had an opportunity to earn revenues associated with that permit. Further, as Australia has no experience with a major carbon market, the industry does not consider that the duration of this arrangement should be constrained in advance. This contrasts with the CPRS proposal to pre-emptively restrict the availability of delayed settlement for future vintage carbon units to only those sold between 1 January 2011 and 31 December 2013.

If this principle were enshrined in legislation, many practical implementation issues would still need to be resolved. One such issue would be when permit receipt and settlement would occur. A few days before surrender date would be the simplest and most logical date for this; however, a more complicated schedule of settlements throughout the compliance year could be developed. For instance, the industry has previously discussed an arrangement under which the Government would receive the majority of cash from permit sales by the end of the relevant financial year.

[8] Investment Reference Group, *A Report to the Commonwealth Minister for Resources and Energy*, April 2011

Taxation arrangements for emissions units

The Association notes that the Government will legislate to make supplies of permits GST-free. This is a welcome improvement on the CPRS position and is strongly supported by the industry as applying GST to normal permit transactions would have imposed an unnecessary working capital burden on businesses. However, the treatment of derivatives will follow their normal course of being subject to GST under the current rules, while the international carbon derivatives trading market will be GST-free (under the normal GST rules). The industry requests that consideration be given to extending the GST-free treatment to carbon derivatives in order to avoid disadvantaging the domestic carbon derivatives market.

esaa remains concerned with the proposed tax treatment under income tax law. In particular, the proposed taxation arrangements for the energy sector's units are inconsistent with the normal taxation and accrual accounting principle that expenses are recognised in the year they are incurred. This treatment leads to unnecessary working capital costs for the energy sector, much of which will already be under significant financial strain because transitional assistance is inadequate.

As set out in the *Clean Energy (Consequential Amendments) Bill 2011*, where a unit is purchased and surrendered in the same income year, a deduction will be allowed in that year.

However, if the unit is retained at the end of the financial year, the effect of the deduction will be deferred until the permit is surrendered or sold. Noting that the compliance date for surrendering units is 1 February in the following financial year, and that a business will not even know its liability until the finalisation of National Greenhouse and Energy Report requirements (which happens after the relevant financial year ends), it is likely that many businesses will retain units at the end of a financial year.

This means that the approach of tying the timing of the deduction to the date of surrender, and not to the year in which the emissions that give rise to the liability occur, can lead to a timing mismatch and is a deviation from normal taxation principles. It will impose an additional and unnecessary working capital burden on the energy industry because entities will have had a taxable uplift in revenue through the partial pass-through of permit costs into wholesale prices. esaa contends that deductions for the cost of permits should be allowed in the year that the obligation arises rather than in the year that permits are surrendered.

Furthermore, the Association does not support the Government's position that administratively allocated permits should be subject to tax. This will result in further cash flow implications for liable entities and will also potentially bias taxpayer decisions to acquit or sell rather than bank administratively allocated permits in order to avoid incurring an unfunded tax liability. This runs counter to the tax objectives of the scheme and could potentially introduce distortions to secondary markets if significant volumes of administratively allocated permits are sold.

esaa considers that the most appropriate tax treatment for administratively allocated units to would be to allocate a nil value which would reflect their historical cost. They would be treated as assessable on receipt but would be allocated a nil value. A nil value deduction would correspondingly arise on use. While such a taxation treatment would not prevent the value of assistance to electricity generators from being further eroded (as generators would still pay additional tax on the partial uplift in electricity prices), it would at least remove the added working capital burdens.

If this approach is not considered acceptable, then an alternative model for the taxation of administratively allocated permits is that offered to emissions intensive trade exposed entities (EITEs) under the Jobs and Competitiveness program. EITEs will be subject to a 'no disadvantage rule' whereby administratively allocated permits held at the end of the initial income year are valued at zero to avoid the timing disadvantages described above.

3. Scheme caps and gateways

esaa has long argued that to provide investment certainty to the energy sector, emissions targets should be set out for as long as possible. In the case of the CPRS, this was to be done through a rolling five-year scheme cap, with up to ten years of 'gateways' to be renewed every five years. This was insufficient for the sector.

However, the position reached in the *Clean Energy Bill 2011* of a rolling five year scheme cap is a backwards step from the CPRS. Default pollution caps that will be in place in the absence of Parliament passing scheme caps are not a substitute for well-defined caps and gateways. Furthermore, the first five years of scheme caps are to be released "no later than 31 May 2014." In the interest of providing information to scheme participants, esaa considers that these regulations should be released much sooner.

It must be remembered that the carbon pricing mechanism involves, at heart, the creation of a market for emissions. In Australia's market-driven economy, the role of the emissions market is to drive emissions reduction by providing price signals to producers and users of emissions about their production, investment and consumption decisions.

Given the importance of the emissions market, it is important that the conditions are in place to support, as quickly as possible, the development of a well functioning emissions market. Importantly, the emissions market in a general sense will have numerous facets, including the primary market, secondary market, derivative markets, and the markets that interface between foreign and domestic emissions prices. To support liable entities managing their emissions obligations at least cost and with maximum flexibility, Australia would benefit from a liquid spot emissions market. To support investors to make large, long-lived investments with confidence, a clear forward price curve is necessary.

One of the conditions necessary to support a clear forward price curve is a forward cap. While the proposed rolling five-year cap is a start, it does not provide the long-term certainty that is required for investment. With energy asset lives well in excess of 40 years, the industry considers that as a minimum, annual emission caps

should be set for a 10-year period that is extended by one year, each year. A further 10-year emissions gateway should also be provided to enable businesses to form a view of future carbon prices over a 20-year period.

One argument that has been put forward against longer caps is that the international forward price can act as a proxy for the forward Australian price. While international forward prices will provide important information bearing on the future Australian price, they will not provide sufficient information in isolation for a number of reasons. For instance, it is not yet clear which international units will be eligible to be imported into the Australian scheme. Only some CERs will be eligible to be imported, and presently it is unknown whether units from the EU or New Zealand can be imported. Further, the bill makes provision for the disallowance of international units in the future.

Secondly, there are numerous international units, so it is not possible to talk about a single "world price" of emissions. There is also ample opportunity for prices of international units to diverge. For instance, price divergence has been observed between units from the European Union's (EU) ETS with those created via the Clean Development Mechanism, known as CERs. Spreads between these prices has ranged from virtually zero to almost ten Euros per tonne over recent years.

Further, international unit prices will be driven by the policy choices of foreign governments and multilateral organisations that are difficult to anticipate and may be in response to country-specific factors, for instance, political decisions about the future use of nuclear energy.

While the Australian emissions markets will receive guidance from international prices for the Australian price, the market would be supported by a longer period of scheme caps and gateways.

Limits on the import of carbon units

esaa's position is that there should be no limits on the import of credible international abatement in order to minimise the cost to Australia of achieving emissions reduction goals. This is both economically and environmentally efficient as, in terms of what the atmosphere sees, it does not matter where abatement occurs. The industry is working through the full implications of the 50 per cent limit on imports. However, as a matter of principle and potentially of practice, the Association contends that the decision to restrict imports of international units to meet scheme liability will impede the flexibility of firms to manage their liability and is another threat that could result in the Australian price diverging from the international price. The decision of how to manage their liability should be left to businesses, rather than imposing an arbitrary cap on where abatement can come from.

4. Scheme coverage

Changes in the coverage of the carbon pricing mechanism compared to the CPRS are of concern to the Association. A comprehensive ETS covering emissions from as much of the economy as possible leads to a more efficient outcome with abatement coming from the lowest cost sources. The CPRS covered all six greenhouse gases and around 75 per cent of total Australian emissions. However, the Government's

proposed carbon pricing package has gone backwards from this position. Only four greenhouse gases will be covered under the carbon pricing mechanism, with the transport and agricultural sectors – the second and third largest sources of greenhouse gas emissions in Australia – excluded from the proposed emissions trading scheme. While some proposed complementary measures may assist, reduced coverage still results in sectors covered by the carbon price and ETS facing greater restrictions than they would otherwise.

esaa's preliminary analysis suggests that the energy sector will be required to surrender around 60 per cent of available units. This forces the sector to do the heavy lifting for the economy, despite inadequate compensation, working capital burdens, insufficient information about scheme caps and gateways to drive investment, and the potential inability to pass-through costs to retail tariffs in some states.

The decision to exclude certain sectors of the economy also results in a lower scheme cap, with fewer domestic units on issue. A smaller emissions market is likely to have less liquidity and be less conducive to the development of a well-functioning and efficient secondary and derivative market. Additionally, should a lack of abatement from uncovered sectors result in a tightening of the scheme cap in order to meet Australia's emissions reduction targets, this will lead to covered sectors being required to do more of the 'heavy-lifting' in order to meet the emissions target. This will produce sub-optimal results, with a higher carbon price than necessary translating into higher costs for households and businesses.

5. Retail price deregulation

An intentional part of pricing emissions in Australia is to allow the price of carbon-intensive electricity to encourage changes in behaviour. The Treasury modelling projects wholesale prices increasing by 40 per cent compared to no carbon price to 2020 and by 100 per cent by 2050. The electricity price consequences of a price on carbon must be addressed constructively.

For a carbon pricing mechanism to operate efficiently and provide least-cost emission reductions, consumers should be exposed to the cost implications of greenhouse gas emissions. Providing efficient price signals to consumers will enable the carbon price to drive abatement on both the demand and the supply side of the energy market. This is demonstrated in the Treasury modelling, which finds that reduced demand from carbon pricing delivers almost half the cumulative abatement to 2020 from the electricity sector.[9] While not reported in the Treasury modelling, a similar type of effect could be expected from the pass-through of emissions cost into gas prices.

esaa considers that the best way to pass through emissions costs and provide end-use customers with appropriate signals to consume efficiently and engage in cost-effective energy efficiency and demand-side management activity is to let retail prices be set by open and competitive retail markets.

[9] This result is driven by an assumption that in the medium term, a 10 per cent increase in wholesale electricity prices leads to a 3 per cent decrease in electricity demand across the economy.

In contrast, the retention of regulated price caps creates the real risk that retailers may be prevented from passing on in a timely manner higher wholesale energy and network related costs, as well as increased prudential costs associated with the carbon price. This could force significant losses for retailers and make them unable to contract forward with generators. Systemic failure or financial distress among major retailers would increase volatility and risks in the energy market, reduce competition and potentially undermine system reliability and security of supply.[10]

Previous commitments from the Government to work with the states, through processes such as the Ministerial Council on Energy (MCE) and the Council of Australian Governments, to move towards retail price deregulation have failed. Only Victoria has de-regulated electricity prices; all other jurisdictions have maintained price control over electricity for small-use customers. With respect to gas regulation, while there has been more progress, three jurisdictions still retain price regulation over small use customers. A recent decision by the Western Australian government to overrule the recommendation of its own regulatory agency to allow a 30 per cent increase in tariffs and allow a privately-owned gas retailer only a 10 per cent increase is a worrying case in point.

The Government is compensating the vast majority of households for the assumed cost impact of the carbon price, with millions being compensated to the point where they will be better off compared to their average impact (which it should be noted was based on Treasury's assumption of full pass-through). In this context, where jurisdictions refuse to commit to retail price control reform, esaa considers that the Commonwealth should ensure that financial penalties are applied. Financial penalties have proven effective in eliciting difficult but necessary energy market reforms in the past.[11]

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[10] The issues with retail price regulation under emissions pricing are examined in work by Farrier Swier Consulting, commissioned by the Energy Retailers Association of Australia in 2009. While this was in the context of the CPRS, which had a different scheme design to the current carbon pricing mechanism, the general points are salient. The report found that to maintain a financially viable and competitive retail sector, retail prices must reflect costs and that there must be flexibility to adjust retail prices quickly. Given that such adjustments are at odds with current retail price regulation governments need to act to remove or change retail price regulation. The report is available here:

http://www.eraa.com.au/db_uploads/Farrier_Swier_Carbon_Pass_Through_Report_Final.pdf

[11] In its 2003 National Competition Policy assessment, the National Competition Council recommended a suspension of 25 per cent of Queensland's competition payments (10 per cent pending implementation of contestability for tranche 4A customers and 15 per cent pending the outcome of the wider review of full retail contestability). In February 2004, the Queensland Government announced the extension of retail competition to tranche 4A customers, which commenced on 1 July 2004. However, by the time of the 2004 assessment, Queensland had still not reviewed the costs and benefits of full retail contestability in accord with its 2003 commitment. The Council therefore recommended that the 15 per cent suspension of 2003-04 competition payments be deducted permanently; it also recommended a new suspension of 15 per cent of 2004-05 competition payments, pending Queensland's completion of the review of full retail contestability and implementation of its findings. The Australian Government accepted this recommendation. On 28 September 2005, the Queensland Premier announced that full retail contestability would be introduced for small businesses and households from 1 July 2007.

However, where retail price regulation remains in place there should, at the very least, be a consistent, national framework for the regulation of both electricity and gas retail prices that enables cost-reflective pricing and the full pass-through of emissions-related costs to consumers.

Drafting issues

The following section provides commentary on key drafting concerns that the Association has identified in the draft legislation.

esaa notes that there is substantial detail still to be provided in regulations. Any subordinate legislation relevant to the sector should be released at the earliest opportunity, and provide for a meaningful consultation period.

Carbon Pollution Cap

The default cap proposed in the *Clean Energy Bill 2011*, while being an attempt to provide certainty on emission caps in the absence of a Regulation being made, could be improved considerably. As currently drafted, the default caps deliver an outcome that appears inconsistent with the overarching reduction goal, and provide limited guidance for anticipating the likely caps set by regulation.

Analysis by esaa suggests that the 12 million tonne reduction from the previous year's cap (as per s18 of the bill) potentially results in the scheme cap reaching zero by around 2040. This would require an unlikely set of circumstances to eventuate, but even disregarding this, the 12 million tonne default represents an increasing proportion of a declining scheme cap. Effectively this results in the covered sectors of the carbon pricing mechanism being required to provide a disproportionate amount of abatement for the Australian economy in the event the default cap is activated.

The Association considers there is a more appropriate approach, whereby the prospect of the scheme cap ever reaching zero is prevented. Possible approaches would be to specify a percentage reduction from the previous year's scheme cap; alternatively it could be the lesser of 12 million or a preset percentage reduction.

Default caps should represent a reduction pathway that is consistent with Australia's 2020 and 2050 targets, rather than a punitive measure taken out against businesses should Parliament be unable to agree on a cap.

Noting earlier comments regarding the shortened window of information on scheme caps and gateways, s18 could also be amended to provide that default caps are in effect an "upper-bound" for any regulations setting scheme caps. Such an approach would provide considerable benefit to the market. It would serve as a useful guide, providing certainty that any cap set by regulation will be lower than the default cap. In this case, the default cap would probably require redesigning from its existing 12 million unit reduction to be appropriate.

Regulations for setting carbon pollution caps

The Minister is required to set the first five years of scheme caps no later than 31 May 2014, according to s16. In the interest of providing information to scheme

participants, the energy industry considers that these regulations should be released as soon as possible.

Section 14 outlines the items to which the Minister may have regard in setting carbon pollution caps. It is considered that these items are altogether too vague in some instances. The industry recommends that subsection 2c(v) be split and amended to read “the cost to the Australian economy of meeting various levels of carbon pollution caps” and “the social implications associated with various levels of carbon pollution caps.”

Similarly, subsection 2c should also make explicit mention of the actions of Australia’s key competitors. While this section does refer to the Minister having regard to “global action to reduce greenhouse gas emissions,” it is considered that there should be a specific reference to key economies. The industry’s proposed addition is that the Minister may make regard to “the actions taken by key economies to reduce greenhouse gas emissions.”

Liable entities

The definition of liability as a person who has operational control is a welcome improvement from the CPRS. Operational control is a definition that has been applied for a number of years now under NGERS and increases the likelihood of a holder of a contract to supply triggering a change of law clause to adjust prices for emissions costs.

Gas issues

The energy industry is supportive in principle of the s33 provisions which set the point of obligation on the natural gas retailer as the liable entity for supply of natural gas. However, there are concerns that “natural gas retailer” is not defined in the legislation. The industry understands that the intent is to place the point of liability under s33 on downstream natural gas retailers, but a clear definition is required to ensure that upstream entities in the natural gas supply chain are not inadvertently captured.

The industry contends that s34 of the exposure draft legislation creates unintended and inefficient outcomes for some non-retail gas consumers, such as small transmission pipelines and other non-retail natural gas users. Section 34 establishes that for the natural gas industry, all facilities will be captured as liable entities regardless of the amount of emissions produced.

For example, small pipeline facilities which emit less than 25,000 tCO_2-e per annum through the combustion of gas in small water bath heaters and compressors are captured under this provision in the legislation. For these types of facilities, compliance costs may exceed the actual carbon permit costs required to comply with the legislation.

It is understood that the rationale behind the application to own use of natural gas is to ensure wide coverage of the natural gas industry, therefore the energy industry would be willing to engage with the Government to provide an analysis of industry data to ensure a credible and workable emissions threshold applies for non-retail

natural gas users. Given the limited time available for consultation on the legislation, it is possible that this issue may be resolved by appropriate wording in supporting regulations.

Finally, it is noted that in circumstances where a person has ceased to be an eligible holder of an Obligation Transfer Number (OTN), the person has no obligation to notify their gas retailer. It is recommended in the interests of satisfactory scheme coverage and minimising disputes, that such a person be obligated to notify their retailer.

Joint ventures and partnerships

The new approach to apportioning point of liability for unincorporated joint ventures (JV) when compared to the Carbon Pollution Reduction Scheme (CPRS) is supported by the energy industry as it allows application of a liability to align with existing commercial practices. It is considered that similar treatment needs to be afforded to partnerships, on which the legislation is currently silent. Alternatively, another potential solution for the treatment of partnerships is for partnerships to be treated as a "person" as defined in the bill.

However, there is an apparent inflexibility for the point of liability in circumstances where one of the joint venturers is also the operator of the facility. Under such arrangements, the *Clean Energy Bill 2011* will impose the point of liability on the operator, with no potential to transfer or apportion across the joint venturers. This inflexibility strays from other provisions and is not supported. It is noted that application of not dissimilar liabilities (such as the Petroleum Resource Rent Tax) applies to the economic beneficiaries of a JV, regardless of who has operational control, and the energy industry considers the carbon pricing mechanism should operate similarly.

Furthermore, the definition of "foreign person" as a body corporate incorporated outside Australia also creates inflexibility. This has the effect of disallowing a foreign corporation registered in Australia under the *Corporations Act* 2001 to carry on a business in Australia and subject to its reporting requirements to be a participant in a voluntary joint venture or having financial control for the purposes of the transfer of liability under a liability transfer certificate.

<u>Coal-fired electricity generation</u>

Part 8 explicitly restricts the allocation of transitional assistance where a generation complex enters into a contract for closure with the Government. The Government's policy announcement states that "generators contracting with the Government to close will be required to forego their administrative allocations (and will not have to comply with associated conditions) but will receive value equal to the foregone assistance plus an additional payment for closure".

While it is understood that payment for closure will be dealt with outside of the legislation it is unclear as to how the administrative allocation of units (and cash payment) calculations for all generation complexes will be impacted by generation complexes claiming both forms of assistance. In order to provide absolute certainty

regarding how assistance will be allocated the bill needs to provide clarity on this issue.

Section 162(1) – *Application for certificate of eligibility for coal-fired generation assistance* states that a "… person may, within 270 days after the commencement of this section, apply for the Regulator to issue a certificate of eligibility for coal-fired generation assistance in respect of a generation complex". Additionally, s165 outlines that the Regulator must respond to an application for the issue of a certificate of eligibility for coal-fired generation assistance within the later of 90 days from the date on which the application was made or 300 days from the commencement of this section.

These provisions present a timing mismatch. The first payment of assistance is due to be made in 2011-12, and generators require a certificate of eligibility to receive assistance. Additionally, the division of a fixed sum of assistance effectively requires all applications to be received and considered before any generators' share can be calculated. However, if applicants can take up to 270 days from the commencement of the bill to apply and the Regulator can take up to 300 days from the commencement of the bill to provide a response; this means that the 2011-12 financial year would be over by the time the decision is made. This could delay the provision of assistance. It is necessary for the time frames to be revised to allow time for the application and decision process while still ensuring that the processes can be concluded before the end of June 2012.

There is also interest in how the Government's buy-back of unused carbon units issued under Part 8 of the bill will operate. Consultation on the discount factor applied which is to be specified in regulations will be crucial for the sector.

Power System Reliability Test

It is noted that the Power System Reliability Test conditions, as drafted, enable entities to meet the test requirements in three ways:

1. The registered nameplate capacity of the generation complex is maintained over time (the status quo approach), or

2. The registered nameplate capacity of the generation complex is reduced over time, but AEMO or IMOWA certifies that there is unlikely to be a breach of the relevant power system reliability standards within two years (the certification approach), or

3. The registered nameplate capacity of the generation complex is reduced, but the person that is registered as a generator for that generation complex also constructs new replacement capacity that complies with the relevant requirements set out in the bill and regulations (the Low Emissions Transition Incentive).

The Association notes the alternative approaches that generators receiving assistance under the Energy Security Fund have available to them to meet the Power System Reliability Test requirements, however, the industry has identified a

number of operational issues and details that require further consideration and clarification.

For instance, the definition of what constitutes a generation complex's "nameplate rating" is unsuitably vague in the bill. It is recognised in the commentary on the bill that the National Electricity Rules define their own concept of a nameplate rating and that this parameter is not actually registered with AEMO. It is proposed in the bill that the Regulator will determine which registered parameter most closely fits the definition of the nameplate rating, and therefore which parameter will be considered when applying the power system reliability test. Further consultation with the industry is recommended to ensure a consistent approach to defining nameplate rating is established.

As drafted, the bill is unclear in defining the decision making criteria that will be applied by AEMO and IMOWA in determining whether a reduction in a generator's nameplate rating will impact system reliability standards. The decision making process used in determining whether certification will be provided to a generator seeking to reduce its registered nameplate rating should be clarified in the accompanying regulations.

Additionally, it appears that the Test results in an 'all or nothing' approach to assistance whereby a small impact on power system reliability, or a slight delay in the submission of a Clean Energy Investment Plan (CEIP) results in the total removal of assistance to generators. This results in disproportionately strong consequences. More discretion is needed so that any reduction in assistance is reflective of the magnitude of the threat to power system reliability or delay in submission of a CEIP, and this principle should be captured in the legislation.

An important feature of the CPRS low emission transition incentive, which applied to replacement capacity under the Power System Reliability Test, was the flexibility provided for market participants. In effect, the operator of an eligible coal-fired generator could withdraw capacity and commercially negotiate for another party to nominate their new capacity as replacement. There are two key benefits of such flexibility. Firstly, it does not bind an incumbent market participant to reinvesting in new low emission capacity and secondly, this flexibility would likely encourage the earlier entry of new lower-emission capacity. The energy industry considers the current drafting is not clear on whether such flexibility has been retained, and recommends clarity in the provision is provided. Further flexibility could be provided by removing the specific requirement for the replacement to be in the "same region".

It is also unclear how AEMO and IMOWA would handle multiple requests for assessment of reliability standards from generators in the event that more than one generator was seeking to reduce their nameplate rating. Questions arising include:

- Would it be on a first come first served basis?
- Would it be based on the relative emission intensity of the generation complexes seeking a review?
- Would it be based on the net emission reduction of alternative closure options?

- Would the timing of certification for multiple generators be modified to accommodate the requirements of all?

The Association has requested that its members be consulted on the design elements of the power system reliability test to ensure that outcomes for the electricity market, and recipients of assistance under the Energy Security Fund, are consistent with the objectives of the *Clean Energy Bill 2011*.

The Association supports the improvements made to the Power System Reliability Test compared to the CPRS, including inserting a timeframe for the market operator to make a statement and clarity that no statement is taken to be the passing of the test.

Clean Energy Investment Plans

Generators receiving assistance under the Energy Security Fund must develop and submit a CEIP to the Minister for Resources and Energy for publication on an annual basis.

The requirement for CEIPs to be published as required by s180 risks commercially sensitive information being disclosed. While the desire for public scrutiny is understandable, there is a risk that the publication of these plans could compromise leadership in innovation.

Apart from the CEIP details discussed in the commentary on the *Clean Energy Future Bill 2011*, the bill itself contains limited detail on what is required to be included in the plan. Details on the information requirements for a CEIP are to be established in regulations made by the Minister for Resources and Energy. The Association has asked the Government to consult widely with affected generators in the development of appropriate reporting requirements.

<u>Auction Design</u>

The details surrounding auction design will be critical for the energy industry. The absence of auction design detail from the draft legislation allows the Government the opportunity to work with and consult actively with industry in designing the legislative instrument to implement auction design arrangements. The industry looks forward to engaging with the Government to discuss draft auction design details as soon as possible. It will be essential that there is adequate time for industry to consult with Government on these arrangements.

The industry notes that the current drafting of the legislation (see section 11(5) would result in the auction needing to be run on a “pay-as-bid” basis, rather than a common clearing price. The industry considers the latter to be more appropriate (and was the proposed mechanism under the CPRS), but also suggests that this matter need not be specified in the legislation.

<u>International Unit Surrender Charge</u>

The *Clean Energy (International Unit Surrender Charge) Bill 2011* explains the circumstances under which a charge will be levied on the surrender of international

units. As the energy industry understands it, the purpose of the International Unit Surrender Charge is to ensure that the price floor that is in operation from 1 July 2015 to 30 June 2018 for domestic units would also effectively apply to international units in years when the international price may be below the Australian floor price. The charge would therefore act as a 'top-up' fee. Nonetheless, much of this detail is to be contained in regulations and as a result the interaction between the floor price and international units is not clear.

The Association considers that lower cost abatement would be better achieved without this charge artificially increasing the marginal cost of overseas abatement. The charge is likely to present a number of practical issues. It seems overly burdensome to implement and unnecessary to maintain the scheme's integrity. It also serves to discourage forward contracting of international units.

The charge could potentially discourage Australian businesses from engaging in primary Clean Development Mechanism (CDM) projects, which typically have a lower price than CERs traded on the secondary market. This is because primary CDM projects entail a greater degree of risk for participants. By imposing a charge on top of this price, it is unlikely that businesses would be prepared to take on this risk, when any potential reward is being taken away by the surrender charge.

The legislation states that the charge in each year will be set in regulations. At this stage there is no available information on how and at what point in a compliance year this charge will be set. The timing of setting the charge (if applicable) will affect the relative risk of purchasing international units early or late in a compliance year. The manner in which the benchmark international price for that year will be determined is also unknown.

Almost all mechanisms to implement the price floor will be inaccurate and too broadly targeted to achieve the overall aim. For example, there is a distinct possibility that there could be one rate for all scheme participants, irrespective of the price that a participant may have actually paid for the international unit. This creates significant risk and uncertainty for scheme participants who may purchase international units in advance of compliance years. For example, a scheme participant who purchases an eligible international unit at AU$20 in 2015-16 may be charged for surrendering this unit in later compliance years if the international price subsequently falls and a surrender charge is set in regulations. This would result in a perverse outcome for scheme participants looking to manage their forward compliance risk.

Suppose also that a charge was imposed day by day based on the spot price for international units. Not only would this be difficult to implement due to the variety of international units, it would also discourage forward contracting as the price in the spot market would be used to determine the charge regardless of the price actually paid by participants.

If the Government insists on maintaining the international unit surrender charge then the energy industry proposes that a self-assessment model, similar to the tax system, is one possible option that could be explored. This could involve businesses which surrender international units reporting the overall price paid for international units with a true-up of any difference between the price paid and the floor price. Alternatively, publication of the future surrender charges by 1 July 2012 would assist the market

and allow informed decisions to be made on contracting international units during the period when the charge applies.

Surrender of eligible emissions units

There is concern over the way in which the Government may disallow the use of certain international units. The industry agrees that it is very important to maintain the environmental integrity of the scheme, and allowing the continued use of flawed international units could compromise this integrity. However, the proposal to prohibit the use of specified international units as of the next financial year is overly strict.

The provision that regulations prohibiting the surrender of specified eligible international units take effect from the following year after the regulations are registered is not supported. This does not provide sufficient notice to businesses of a change of law and is an inappropriate allocation of risk. Furthermore, it discourages the development of international emissions markets as it creates risks for businesses in establishing contractual arrangements for supplies of international units. While noting the need to ensure the environmental integrity of the scheme, it is suggested that there be no retrospective application of any changes in eligible international units (noting that the Government has the option of purchasing additional abatement to redress any environmental concerns). Alternatively compensation could be paid to the holders of prohibited international units negatively affected by the change of eligibility.

A transitional period of time is not without parallel elsewhere in the *Clean Energy Bill 2011*, as Section 157 states that "changes that will have a negative effect" should not take effect before "the end of the 3-year period that began when the change was announced." A similar timeframe should therefore apply to liable entities holding such units in their Registry accounts.

Information-gathering powers and monitoring powers

The Association opposes the powers vested in the Regulator with respect to information gathering (Part 13) in that the Regulator may require disclosure for very broad reasons, such as seeking information relevant to the operation of the Act or substantiating information.

The Association considers that powers conferred under Part 13 should be contained to only those circumstances where the Regulator has a reasonable belief that breach or non-compliance has occurred or for the direct purposes of assessing compliance.

In addition, the monitoring powers conferred under Part 15 should be contained to only those circumstances where a breach or non-compliance has occurred or for the direct purposes of assessing compliance.

Further, the requirement for compliance s221(4) should be qualified as reasonably capable, in that business capability to respond to the Regulator may be present but detrimental to other operations. This qualification would balance the extensive nature of the following provisions of s221(5).

Unit shortfall charge

The shortfall charge of 130% of the carbon price in a fixed price year, and 200% of the benchmark average auction charge in other years, results in an additional penalty given that it is not tax deductible. This is a severe penalty for an offence which may have been the result of an entity's annual emissions being revised after the surrender date for a financial year. This would result in an entity paying a shortfall charge despite having acted in good faith in reporting emissions, which were then revised upwards.

The Association argues that the unit shortfall charge should be reduced from its level of 200% of the benchmark average auction charge in a flexible charge year. At a minimum, however, the unit shortfall penalty should be tax-deductible. This approach maintains a strong penalty for non-compliance, while not being excessively onerous.

Taxation

First-in-first-out (FIFO) Rule

The industry did not support the application of a FIFO treatment for emissions units of the same vintage where the cost method is applied, as proposed in the CPRS Exposure Draft legislation. The energy industry therefore welcomes the Government's decision to allow businesses to choose whether or not to use the FIFO method when accounting for the value of permits.

Valuation Methodology

Under item 420-55, tax payers are able to value all units held at the end of an income year at cost, using the (FIFO) cost method, the actual cost method, or at market value. Tax payers will have the choice of changing valuation methodologies once until 2014-15. From then on, tax payers will be able to change their valuation methodology after they have used a methodology for at least the four previous years that units were held at the end of the income year. This is a notable improvement from the CPRS when tax payers were only able to change valuation methodologies once during a transitional period, before that valuation methodology was locked in.

Deductions under Division 420

Item 420-15(2) allows deductions for expenditure incurred in becoming the holder of an emissions unit but only in the income year in which you start to hold the permit. It would be simpler to allow eligible expenditure to be deducted as incurred.

Item 420-15(3)(b) indicates that deductions cannot be claimed for expenditure incurred in becoming the holder of an emissions unit issued in accordance with Part 8 (coal-fired electricity generation) of the Act. The industry understands this provision was intended to keep such expenditure out of the rolling balance but not deny deductions under other provisions. A clarifying note to this effect should be included in the legislation.

Same Business Test

The Association has requested confirmation from the Government that trading in permits does not constitute the undertaking of a new business for the purposes of the Same Business Test.

Stamp duty

The Association notes that generally stamp duties are outside of the federal government's jurisdiction. However, under cl.B4 of the Intergovernmental Agreement on Federal Financial Relations which operates from 1 January 2009, State and Territory Governments agreed not to levy stamp duties on the transfer of emission trading permits after 1 July 2013. The Association has asked the Government to ensure that States maintain this agreement in order to provide certainty to industry.

Governance arrangements

The Clean Energy Future package outlines the Government's intent to establish several new agencies to oversee the carbon pricing mechanism and to assist in the transition to a low emissions economy. These include the Climate Change Authority, the Clean Energy Regulator, the Clean Energy Finance Corporation and the Energy Security Council. Whilst the roles of the Authority and the Regulator are spelled out in regulation, there is no mention of either the Energy Security Council or the CEFC.

Energy Security Council

The Clean Energy Future legislative package provides no details as to the make-up or role of the Energy Security Council. It is important for the industry to have clarity over the arrangements supporting the establishment of this Council, given the proposed role of it as stated in the Clean Energy Future policy documents. The Association has called on the Government to release details in legislation or regulations as soon as possible, and to provide for consultation with industry.

Clean Energy Finance Corporation (CEFC)

This body could have a valuable role to play in helping emergent technologies to overcome barriers caused by financial market failures in the low-emissions generation sector. However, it must be recognised that there is already a scheme, the Renewable Energy Target, which is the primary mechanism for facilitating the deployment of renewable energy in Australia and should remain so.

Nevertheless, to the extent that there are market failures that arise from factors such as a limited understanding of newer technologies, an overestimation of the risks associated with a particular type of plant or a preference in the market for short-term over long-term returns, then there will be scope for the CEFC to fund projects that are unable to secure private funding on reasonable terms.

However, there is a risk that providing finance on a concessional basis could result in the Government – regardless of the independence of the Corporation – crowding out private finance. Additionally, where concessional finance is provided to firms wishing to participate in competitive dispatch markets such as the NEM or WEM, this could result in a subsidy to new participants at the expense of existing generators. This

distortion would come against the backdrop of fundamental shifts in generation that will take place under a carbon price, and could undermine the prospects for privately financed low-emissions generation.

The Association considers that further detail is required to understand the impact of the CEFC on electricity markets.

Conclusion

For Australia to continue to enjoy a reliable, competitive electricity supply while also reducing its greenhouse gas emissions as a society, it must be very careful in its policy choices.

The Association has been calling for a well-designed emissions trading scheme since February 2007 and the features of such a scheme are enumerated in countless public policy processes. The key is to strike a balance between introducing incentives to transition the sector towards lower emissions generation and maintaining an orderly transition. Any carbon pricing mechanism must deliver abatement; provide clear and timely signals for new investment; and manage the transition for emission intensive plant and address impairment of legacy assets to ensure reliability and security of electricity supply. Anything short of this would constitute policy failure. Given how deeply embedded the energy industry is into modern Australia, every Australian household and business has a stake in getting it right.

Any questions about our submission should be addressed to Temay Rigzin, by email to temay.rigzin@esaa.com.au or by telephone on (03) 9670 0188.

Yours sincerely

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