Exigency

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The Secretary
Senate Select Committee
on the Scrutiny of New Taxes
PO Box 6100
Parliament House
Canberra ACT 2600

Senate Inquiry on "a carbon tax, or any other mechanism for putting a price on carbon"

Exigency was established in 2003. It is an independent energy and carbon market advisory firm, serving clients on Energy and Greenhouse Strategy as well as providing advice and project support in the delivery of sustainable and low carbon intensity infrastructure (www.exigency.com.au).

In making this further submission, Exigency is:

- expanding on its original submission to the Senate Select Committee of 13 April;
- drawing on further research undertaken by Exigency on carbon pricing mechanisms;
- reflecting on its initial review of the Clean Energy Bill 2011 Exposure Draft.

Overarching Comments

In making this submission, we have assumed that the "Heisenberg Clause" (Clean Energy Bill 2011 Exposure Draft Section 307, Alternative Constitutional Basis) correctly confers the power on the Commonwealth to "price carbon" and does not require a further referral of powers from the States.

There continues to be considerable confusion in the media, via opinion pieces and reportage from Canberra as to the difference between a carbon permit and a carbon credit. The former is an emissions right and is applied as a penalty, whilst the latter is an amount of certified abatement that is applied as an incentive. Certain prescribed "credits" may be submitted in lieu of a permit in a penalty based scheme.

Each is represented by 1 tonne of CO2-equivalent. The term "Permit" is commonly misapplied to abatement credits. This may be the cause of some ignorance on how the various carbon pricing mechanisms work – and mask a fundamental paradox at the core of the Clean Energy Bill.

This may also go part way to explaining why the Government claims that "putting a price on carbon" (i.e. applying a penalty to carbon "pollution") is "recognised by economic experts around the world to be the most environmentally effective and cheapest way to cut pollution"[1].

[1] Clean Energy Future. What a carbon price means for you.

Rather, economists have tended to argue that "market mechanisms" and/or "emissions trading schemes" provide the most environmentally effective and cheapest way to reduce emissions, without differentiating between permit and abatement mechanisms. In describing Emissions Trading Schemes in its report: Carbon Emissions Policies in Key Economies (May 2011), the Productivity Commission concluded:

> "Emissions trading schemes were found to be relatively cost effective, while policies encouraging small-scale renewable generation and biofuels havegenerated little abatement for substantially higher cost".

In so doing, the Productivity Commission ascribed the term "emissions trading schemes" to incentive schemes (specifically the NSW Greenhouse Gas Abatement Scheme) as well as penalty schemes (such as the European ETS).

Contrary to the Government's claims, our own research lends weight to the view that incentive schemes, such as the Clean Development Mechanism and the Chicago Climate Exchange achieve greater environmental outcomes, at lower cost than the penalty based alternatives.

These mechanisms are not without problems. However, at a minimum, they are more transparent and carry less regulatory burden then their penalty based counterparts. In contrast, penalty schemes such as the EU ETS pose substantial challenges in even assessing whether and to what extent they have been causal in achieving environmental outcomes.

Ironically, Treasury modelling indicates that the Carbon Pricing Mechanism will rely on overseas markets for around two thirds of greenhouse gas abatement, by 2020. We envisage that the bulk of this will be delivered through the Clean Development Mechanism, an incentive based market mechanism.

Comments on the Carbon Pricing Mechanism as set out in the Clean Energy Bill 2011 Exposure Draft.

Broadly, this should be seen as a market mechanism with regulatory intervention aimed at managing carbon prices through a "pricing collar" from 2015. In practice, this will require considerable, finely honed regulatory and market oversight capabilities.

To illustrate this, a price cap can be managed by issuing more permits – as long as the carbon account is balanced by carbon credits, or subsequent permit buy-backs. Similarly, buy-backs could be deployed to manage a price floor – but it will be difficult to avoid arbitrage between the permit price floor and the price of carbon in international markets.

This regulatory complexity, coupled with the restricted coverage of the scheme and the potential for the inefficient allocation of permit proceeds, leads us to question whether this scheme can indeed claim to be "the least cost method of reducing emissions".

The Fundamental Paradox of the Carbon Pricing Mechanism

We note in the announcements accompanying the Multiparty Climate Committee agreement and associated Treasury Modelling that two thirds of the 2020 5% reduction target (ca 100million tonnes of CO2-e) will be sourced internationally.

Theoretically, this could be achieved by acquisition (and surrender) of international permits (i.e. emissions rights) – restricting the ability of liable parties to emit CO2-e in markets outside of Australia, such as New Zealand or the EU. However, this would only work if there were genuine permit scarcity thereby achieving genuine marginal abatement. This condition is not met in the EU (one report suggest that there is currently a surplus of 1.4 billion permits – or 3 years of supply) and we would caution any government or regulator in the strongest possible terms against "bridging" to other trading schemes without the establishment and observance of stringent convergence criteria.

More likely, abatement will be achieved through Certified Emissions Reductions from the Clean Development Mechanism projects in non-Annex B "Developing Countries". To a lesser extent, credits may be acquired through a similar mechanism, known as the Joint Implementation Programme, involving Annex B "Developed" Countries.

Briefly, the CDM is an economy wide incentive scheme, drawing credits from: HFC, PFC & N2O[2] reduction; renewables; CH4 reduction, cement and coal mine/coal beds; Supply Side Energy Efficiency; Demand Side Energy Efficiency; and Afforestation and Reforestation projects.

The CDM was ratified under Article 12 of the Kyoto Protocol in December 1997, but grew progressively from the signing of the Marrakesh Accord (November 2001).

At that stage (2002), the combined GDPs of the BRIC economies (Brazil, India & China)[3] were a little under six times that of Australia. By 2016, the first full year of the Carbon Pricing Mechanism under a "floating" permit price, this ratio is forecast to be just over 10 times. Together, the BRIC economies account for over 70% of CDM pipeline projects[4].

That is, with the shift in the economic centre of gravity away from the Developed Countries and towards the BRIC economies in particular, the CDM, whilst having been a reasonably effective mechanism, appears increasingly anachronistic.

We find it paradoxical, and sub-optimal from the point of view of international competitiveness, that the proposed Carbon Pricing Mechanism will apply penalties (either directly through permits, or indirectly, through increased electricity prices) to Australian businesses, whilst their competitors in the BRIC economies are paid to reduce their emissions. These incentive payments may potentially be made by Australian businesses who are liable entities under the scheme, voluntarily by Australian entities outside the scheme or by the Australian Government of the day purchasing international abatement to balance the "national" carbon account.

[2] Hydrofluorocarbons, Perfluorocarbons and Nitrous Oxide
[3] IMF World Energy Outlook, April 2011, USD nominal.
[4] http://cd4cdm.org/

This policy contradiction appears to have escaped scrutiny to date – perhaps in part because of the confusion between "permits" and "credits". However, this anomaly ought to be of concern to all stakeholders, including shareholders, employees and representative organisations alike.

Potential for Distortion of the Clean Energy Market

The $13 billion of funds allocated to the development of the clean energy market has the potential to wreck this developing industry. In addition to independent oversight of the allocation of funds, there needs to be reinvigoration of currently stalled COAG energy market reforms, without which, carbon policy effectiveness will be severely constrained and productivity will be compromised. Two key reforms would be:

1. Remove restrictions to grid connection of renewable and distributed generation schemes (as has already happened in NZ and the UK, with the most basic "smart grid" technologies); and
2. Introduce a locational signal into renewables subsidies, reflecting the carbon intensity of the generation they displace, rather than the indiscriminate MWh-based rate that is currently applied.

To expand on the concerns above, to the potential for abuse, the need for additional regulation and the overarching question of economic efficiency and cost would take more time than is currently available to us. But it is for the above reasons that we have fundamental concerns about the effectiveness of the proposed scheme.

In short, we are of the view that the current policy has been selected from a narrow range of penalty based schemes with insufficient consideration of the alternatives, and despite the ready availability of evidence in support of these alternatives.

Once more, Exigency would be pleased to address Senate Members in person if appropriate, to expand on the matters raised here.

Yours Sincerely

Stuart Allinson

Adrian Palmer