MASTER BUILDERS
AUSTRALIA

7 September 2011

The Secretary
Senate Committee on the Scrutiny of New Taxes
Parliament House
Canberra ACT 2600

Email: newtaxes@aph.gov.au

Dear Sir/Madam

RE: Inquiry into Carbon Tax Pricing Mechanisms

Master Builders Australia (Master Builders) welcomes the opportunity to make a submission to the Committee for its Inquiry into Carbon Tax Pricing Mechanisms.

The building and construction industry will be one of the most adversely impacted sectors in the Australian economy if the proposed CPM enters into force.

According to modelling and forecasting undertaken by the Commonwealth Treasury, the proposed CPM will reduce gross output in the construction sector by 5.6 per cent by 2050, considerably more than the falls predicted for the mining (down 4.3 per cent), manufacturing (down 2.8 per cent) or the services sectors (down 1.2 per cent).

Absent any sectoral specific compensation and/or structural adjustment assistance, as has been offered to, for example, the electricity, mining and transport industries, investment and employment in the building and construction sector (currently accounting for 8 per cent of Australia's GDP and more than 9 per cent of employment) will suffer.

The proposed CPM will also have an impact on homebuyers and renters, adding around $5000 to the cost of a modest home (at a carbon price of $23 per tonne), a figure which will rise as the carbon price increases under the Federal Government's 'Securing a Clean Energy Future' framework, exacerbating housing (un)affordability pressures in many parts of Australia.

The recent move from a 'five star' to a 'six star' energy efficiency rating has added around $9200 to the build cost of modest family home, without any compensating adjustment to home buyers. More broadly, the Federal Government needs to act to eliminate such regulatory duplication/ overlap between the numerous 'energy efficiency' programs, and the inefficiency costs which flow therefrom. In combination, this means an increase of more than $14,000 in the cost of a new home.

The proposed CPM will also amount to a 'double-whammy' for many home buyers and renovators, who are already contributing to carbon abatement in Australia through the 'six star' energy rating system for residential dwellings.

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Following the principle established with the introduction of a Goods and Services Tax (GST), Master Builders recommends the Federal Government compensate first home buyers for the expected cost of the CPM by lifting the value of the First Home Owners Grant to $12,000 in the June Quarter 2012, with guaranteed indexation in line with movements in the price impact of the CPM.

Finally, Master Builders would like to record it concern at the substantial market power future Australian Governments will possess as the monopoly originator of domestic emissions permits, augmented by proposed regulation-limited competition from international-sourced emissions permits, implying a lesser efficient market and higher cost for tradeable permits. This will, in turn, add to input costs for liable entities, which will flow on to other producers and eventually to householders.

A copy of the Master Builders' submission, addressing these and other aspects of the proposed CPM, is attached for the consideration of the Committee. Should the Committee wish to discuss these, or any other matters related to the proposed CPM, please do not hesitate to contact me.

Yours sincerely

Wilhelm Harnisch
Chief Executive Officer

MASTER BUILDERS
AUSTRALIA

Submission to

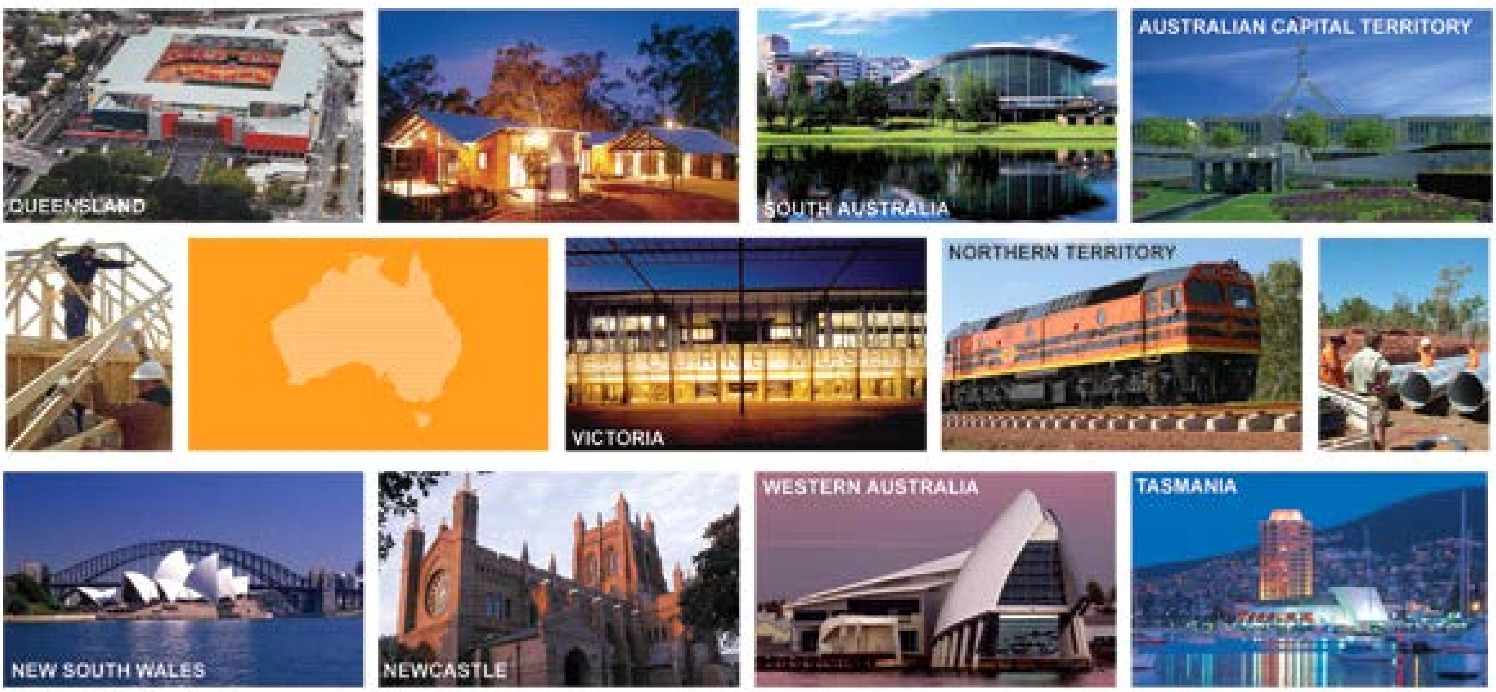
The Select Committee on New Taxes

Inquiry into Carbon Tax Pricing Mechanisms

September 2011

Master Builders Australia Ltd ABN 68 137 130 182

building australia



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1 INTRODUCTION

1.1 This submission is made by Master Builders Australia Ltd (Master Builders).

1.2 Master Builders Australia is the nation's peak building and construction industry association, which was federated on a national basis in 1890. Master Builders Australia's members are the nine Master Builder State and Territory Associations.

1.3 Over the past 121 years, the Association has grown to more than 31,000 businesses nationwide, including the top 100 construction companies.

1.4 Master Builders is the only industry body which represents all three building and construction sectors: residential, commercial and engineering.

1.5 The building and construction sector accounts for close to 8 per cent of gross domestic product, and more than 9 per cent of employment, in Australia.

2 PURPOSE OF THIS SUBMISSION

2.1 The purpose of this submission is to respond to the invitation from the Senate Select Committee on (the) Scrutiny of New Taxes to provide a submission to its inquiry into the proposed Carbon Pricing Mechanism.

2.2 Key terms of reference require the Committee to consider, amongst other things: the short and long term impact of such initiatives on the economy, industry, trade, employment and inflation; the revenue and any related spending implications of the proposed arrangements, and the likely effectiveness of, and alternate approaches to, such measures in achieving the stated policy objectives.

2.3 This submission focuses on the likely impact of the CPM on the building and construction industry, and homebuyers and renters as critical consumers of the products and services of the sector.

2.4 In doing so, Master Builders also places on the public record our assessment of the implications of, and attitude toward, the proposed carbon pricing mechanism (CPM) as announced by the Federal Government in its *"Securing a Clean Energy Future"* (SCEF, 2011) package released on 10 July 2011.

2.5 However, this submission was developed and made to the Committee before the tabling in the Federal Parliament of the full and final package of legislation to convert the policy proposals contained in the SCEF package into law.

2.6 Against this background, Master Builders reserves the right, should the opportunity be available, to make a supplementary submission to the Inquiry, taking into account any new or additional information revealed in the legislation.

3 RECOMMENDATIONS

3.1 The Commonwealth Treasury undertake as necessary, and fully report and make public, revised modelling and forecasts of the impact of the proposed CPM using the parameters of the SCEF (2011) policy package;

3.2 The Federal Government establish and support a government-industry working group to oversight detailed modelling and forecasting by the Commonwealth Treasury of the impact of the proposed CPM on the building and construction industry, giving particular attention to issues such as housing affordability, and consider approaches to compensation to the sector, and the dealing with the overlap of the CPM and other federal, state and territory government 'energy-efficiency' initiatives.

3.3 The Federal Government compensate first home buyers for the expected cost of the CPM on residential housing by commensurate increases in the value of the First Home Owner Grant. This would mean a nominal value for the Grant of $ 12,000 in June Quarter 2012, with guaranteed indexation in line with movements in the price impact of the CPM;

3.4 The Productivity Commission review the effectiveness of the 'Jobs and Competitiveness Program' in mitigating productive capital flight (or 'carbon leakage') in response to the imposition of the CPM. Such a term of reference should be in addition to those already prescribed (SCEF, 2011: 111) for the Productivity Commission for reviewing the 'Jobs and Competitiveness Program';

3.5 The Commonwealth Treasury revise and reissue the modelling and forecasts undertaken for its SGLP report using a 'standstill' scenario for global action on GHG emissions; and,

3.6 Insofar as a CPM enters into force in Australia, liable entities have unfettered discretion as to where they source any required permits/credits, including up to 100 per cent of their requirements from international sources, without prejudice. This approach will facilitate the availability of permits/credits in the most efficient manner, at least cost, in deeper and more competitive markets.

4 BACKGROUND

4.1 The central feature of the Federal Government's SCEF program is a proposal to introduce a mechanism to price carbon emissions in Australia (also known as a carbon tax). Under this arrangement, inter alia:

4.1.1 Pollution gaps will be set by the Federal Government taking into account, amongst other things, Australia's medium and long term national emission reduction targets. These caps will be set and announced annually on a five-year ahead 'rolling window' basis (SCEF, 2011: 103);

4.1.2 Liable entities will be required to purchase emissions permits or credits either domestically or on the international market, or from other approved sources (in the case of credits) (SCEF, 2011: 103). A liable entity will be a facility emitting more than 25,000 tonnes of $CO_{2\text{-}e}$ (SCEF, 2011: 105), presumably annually;

4.1.3 Permits will be made available in 'single tonne' units, have the legal status of personal property, and be regulated as financial products, transferrable and not have an expiry date (SCEF, 2011: 106);

4.1.4 Liable parties will have limited recourse to international permits. Until 2020, liable parties will be required to meet at least 50 per cent of their annual liability with domestic permits or credits (SCEF, 2011: 107);

4.1.5 The CPM will be introduced in phases. The first (‘fixed price’) phase will operate for three years from 1 July 2012, and the second (‘flexible price’) phase from 1 July 2015.

4.1.5.1 During the ‘fixed price’ phase, the price of permits will start at $23 per tonne $CO_{2\text{-}e}$, rising annually by ‘inflation plus 2.5 percentage points’ until the commencement of the ‘flexible price’ phase. An unlimited number of permits will be available for purchase for each compliance year during the ‘fixed price’ phase at the applicable regulated price (SCEF, 2011: 103);

4.1.5.2 During the ‘flexible price’ phase, the price of permits will be largely determined by the market, within the bounds of a price ceiling and floor set by the regulator expected to be: for the ceiling, $20 above the international price in 2015/16 (with inflation-plus escalation); and, for the floor, $15 absolute (also with inflation-plus escalation), for three years from 1 July 2015. Domestic permits will be auctioned, and bankable by permit holders (SCEF, 2011: 104)

4.1.6 The purchase and sale of permits will be subject to Australian taxation law. In broad terms, the cost of a permit will be tax-deductable, and the proceeds from the sale of a permit will be treated as assessable income (SCEF, 2011: 109).

4.1.7 The CPM will be governed by two federal agencies, a Climate Change Authority and a Clean Energy Regulator.

4.1.7.1 The Climate Change Authority will, inter alia, advise the Federal Government on future annual pollution caps, and review and advise on the design and operation of the CPM (SCEF, 2011: 110); and

4.1.7.2 The Clean Energy Regulator will, inter alia, determine the liability of each entity, allocate permits (both freely allocated and auctioned), and enforce compliance with the CPM (SCEF, 2011: 111).

4.2 The Senate Select Committee on (the) Scrutiny of New Taxes initiated on 30 September 2010 an inquiry into, inter alia, a CPM/ carbon tax.

5 OVERVIEW

5.1 The Federal Government has proposed a major structural change to the Australian economy, in the form of its SCEF framework.

5.2 While other major structural reforms of the past generation – the 'floating' of the Australian dollar, deregulation of financial markets, tariff reductions and other trade liberalisation initiatives, progressive labour market reform, and the introduction of a Goods and Services Tax – have delivered positive dividends for economic growth and efficiency, the proposed CPM will subtract from, rather than add to, our economic future performance and prospects (see paragraphs 4.3, 6.4, and 6.10).

5.3 Amongst the economic effects of the SECF framework, according to modelling analyses and forecasting by the Commonwealth Treasury in its "*Strong Growth, Low Pollution: Modelling Carbon Pricing"* (SGLP, 2011) report, are:

5.3.1 lower national income (SGLP, 2011: 6 & 14) and national output (SGLP, 2011: 72), higher inflation (SGLP, 2011: 10), lesser investment (SGLP, 2011: 87) and lower real wages (SGLP, 2011: 88),

5.3.2 with, in Master Builders' view, at best, only a negligible impact on global greenhouse gas (GHG) emissions.

5.4 Master Builders notes Australia's carbon pollution amounts to (just) 1.5 per cent of global GHG emissions annually (SCEF, 2011: 11).

5.4.1 This figure implies a 5 per cent reduction in our GHG emissions would reduce the global volume of such emissions by around 0.08 of a percentage point.

5.5 By comparison, four countries – China, the United States, Russia and India – account for almost half (just over 47 per cent) of global GHG emissions.

5.5.1 A 5 per cent reduction in the GHG emissions of these four countries would reduce the global volume of such emissions by around 2.4 per centage points – or 1.6 times Australia's total annual emissions.

5.6 These figures underscore the (in)significance of (unilateral) action by Australia absent co-ordinated global action on what is regarded to be a global problem.

6 THE MODELLING FRAMEWORK

6.1 A critical foundation of the analytical case for the CPM proposed by the Federal Government in its SCEF framework is economic modelling and forecasting undertaken by the Commonwealth Treasury (SGLP, 2011).

6.2 A key element of the modelling and forecasting framework is a starting price of $20 per tonne $CO_{2\text{-}e}$ on 1July 2012, growing at a rate of 5 per cent per annum plus inflation before the movement to a floating, market-determined price from 1 July 2015 (SGLP, 2011: iii).

6.3 This fulcrum assumption for the modelling and forecasting is materially different from the policy framework announced by the Federal Government, which sees an initial carbon price of $23 per tonne $CO_{2\text{-}e}$, rising by 2.5 percentage points plus inflation per annum during the regulated price phase (SCEF, 2011: xiii).

6.4 **Master Builders Recommend: The Commonwealth Treasury undertake as necessary, and fully report and make public, revised modelling and forecasts of the impact of the proposed CPM using the parameters of the SCEF (2011) policy package.**

6.5 A second critical assumption in the modelling is that entities in Australia liable under the CPM will be able to access "*unlimited international permits over the entire period"* (SGLP, 2011: iv).

6.6 The phrase *"unlimited international permits"* implies liable firms will be able to purchase some or all, at their own discretion, of the required permits either from domestic (Australian) or international (eligible foreign) sources.

6.7 This assumption is inconsistent with the SCEF policy statement (SCEF, 2011: 107) limiting the access of liable entities in Australia to international permits, requiring that "*(u)ntil 2020, liable parties must meet at least 50 per cent of their annual liability with domestic permits or credits."*

6.8 The proposed Climate Change Authority (CCA) review in 2016 (SCEF, 2011: 107) of this regulatory constraint leaves open the prospect such an impediment to market-based competition could remain in place beyond 2020.

6.9 Similarly, if the 'global action scenarios' assumed in the Commonwealth Treasury modelling and forecasting are not realised (for the reasons set out below: see Paragraphs 7.5 - 7.6), the supply of international permits will be less than assumed, and the market-power of the Australian Government as a monopoly-supplier of domestic permits that much greater; as will be political risk for liable entities requiring permits.

6.10 Another important, but unstated, assumption in the Commonwealth Treasury modelling concerns the importance of economic flexibility in the Australian economy, and in particular the capacity and speed with which the economy, commerce and industry, and households are able to undertake the necessary structural adjustments.

6.11 For example, the Commonwealth Treasury implies the labour market adjustments required by the introduction of a CPM will take place through lower real wages (growth in which is 1.1 per cent lower over the 2010 – 2020 period compared to the reference case) rather than through employment (growth in which is expected to unaffected by the new policy settings) (Frontier Economics, 2011: 12).

6.12 Structural adjustment (read: flexibility) in the commercial and industrial sectors of the Australian economy will also play an important role in realising the emissions targets set down in the SCEF package.

6.13 According to the Commonwealth Treasury modelling (SGLP, 2011: 78), around two-thirds of the reductions in emissions intensity in the Australian economy over the period to 2050 will be sourced within industries, with the remaining one-third attributable to industry restructuring.

6.14 The broader economic and industry policy implications of such assumptions are clear: to the extent an Australian Government steps back from progressing pro-liberalisation economic and industry policies, the greater will be the barriers to/ costs of structural adjustment, and the adverse economic and industry effects and costs for householders and small businesses, of the proposed CPM.

7 BUILDING INDUSTRY IMPACTS

7.1 Master Builders notes there is a substantial volume of information, including modelling analyses and forecasting, of the potential impact of the Federal Government's proposed CPM, and variants thereof, already in the public domain.

7.2 Prominent amongst these modelling analyses and forecasts are works by the Commonwealth Treasury (2011), Deloitte Access Economics (DAE, 2011), Frontier Economics (Frontier Economics, 2011) and the Queensland Treasury (Queensland Treasury, 2011).

7.3 This submission will focus on those parts of these analyses which touch on the building and construction industry.

7.4 According to sectoral analyses and forecasts undertaken and reported by the Commonwealth Treasury (SGLP, 2011: Tables 5.6 and 5.7), the construction sector will be amongst the hardest hit by the proposed CPM.

7.4.1 When modelled as 'core policy compared to global action scenarios', the gross output of the construction sector is expected to be 0.9 per cent lower than otherwise by 2020. This compares to falls in gross output of 0.3 per cent for the services sector and of 0.8 per cent for the mining sector. By contrast, manufacturing output rises by 0.2 per cent and agricultural output by 0.4 per cent.

7.4.2 By 2050, the figures for gross output for each sector become: construction, down 5.6 per cent; mining, down 4.3 per cent; manufacturing, down 2.8 per cent; services, down 1.2 per cent; and agriculture, up 1.7 per cent (the latter, likely benefitting from its exemption from the direct burdens of the carbon pricing mechanism, and gains the Carbon Farming Initiative).

7.5 Regrettably, despite these sizeable adverse impacts on the construction sector, and its importance to the Australian economy (and the structural adjustment requirement implicit in SCEF framework),

7.5.1 the Commonwealth Treasury did not provide the same degree of modelling analyses and reporting as it did for the electricity generation or transport sectors (SGLP, 2011: 101 – 120)

7.5.2 nor was there adequate consultation with the building and construction industry on the broader design principles and operational framework for the proposed CPM, as would appear to have been the case with several other heavily, adversely impacted industries and sectors (eg electricity, mining and transport).

7.6 Master Builders Recommend: the Federal Government establish and support a government-industry working group to oversight detailed modelling and forecasting by the Commonwealth Treasury of the impact of the proposed CPM on the building and construction industry, giving particular attention to issues such as housing affordability, and consider approaches to compensation to the sector, and the dealing with the overlap of the CPM and other federal, state and territory government 'energy-efficiency' initiatives.

7.7 Master Builders has commissioned the Centre for International Economics (CIE) to undertake a rigorous analysis of the impact of a CPM on the building and construction industry.

7.8 At the time of writing (early September 2011), the CIE has delivered a preliminary report to Master Builders (CIE, 2011) with a final report due in the near future.

7.9 In general terms, the CIE's preliminary report identified a number of channels through which a CPM could impact the building and construction sector. This would include by impacting on:

7.9.1 costs: raising the absolute costs of materials (eg steel, cement, glass) and other inputs (eg energy and labour) used in building and construction;

7.9.2 production processes: changing the relative prices of different materials and inputs, and inducing a shift in research and development practices and technical possibilities; and,

7.9.3 demand: by slower-than-otherwise economic and income growth, and potentially driving a change in consumer preference for different types of buildings.

7.10 Modelling undertaken by the CIE estimated and reported the effects of a number of 'carbon price' scenarios, ranging from $10 to $60 per tonne $CO_{2\text{-}e}$.

7.11 At \$25 per tonne $CO_{2\text{-}e}$ (the closest scenario to the \$23 per tonne $CO_{2\text{-}e}$ used in the Federal Government's SCEF framework), the CIE found there would likely be increases in the costs of all of the inputs used in building and construction (compared to a 'business-as-usual' or no carbon tax, baseline scenario).

7.11.1 These cost increases would range from: 1.1 for business services, 1.2 per cent for trade services; 1.6 per cent for wood products; 2.0 for transport; 2.1 per cent for metal products; 3.8 per cent for mineral products; and, 4.3 per cent for metals.

7.11.2 Taken as a whole, and depending on the degree of input substitution in building and construction processes, a carbon price of \$25 per tonne $CO_{2\text{-}e}$ could be expected to raise construction costs by between 1.1 per cent (higher substitution scenario) and 1.6 per cent (lower substitution scenario).- implying a mid-point figure of around 1.4 per cent.

7.11.3 Using median house price data for the month of July 2011, and absent any express compensation package for home-buyers, this would suggest an increase in housing prices of between \$4,800 (in the higher substitution scenario) and \$6,900 (in the lower substitution scenario).

7.11.4 Looked at another way, a CPM without compensation for the building and construction industry could be expected to add the following amounts to median house prices: Sydney, \$7,000; Canberra, \$6,900; Melbourne, \$6,700; Perth, \$6,400; Darwin, \$6,000; Brisbane, \$5,900; Adelaide, \$5,300; and, Hobart, \$4,500.

8 HOUSEHOLDS PAYING TWICE

8.1 Master Builders contends the application of the proposed CPM to the residential building sector, in essence, amounts to 'double whammy' for the industry, and 'paying twice' by the householder-consumers of its products and services – that is, purchasers of new homes and those undertaking extensions/ renovations of existing homes.

8.2 Public policy makers do not appear to adequately recognise, and take into account, new home buyers/ home renovators are already making a meaningful contribution to carbon abatement in Australia through the 'six star' energy rating system of residential dwellings. This regulatory requirement is expected to reduce emissions by 500 Kt $CO_{2\text{-}e}$ annually.

8.3 The overall cost to the community of the 'six star' regulatory impost has been estimated by the Federal Government (ABCB, 2009) at $444 million for the thermal shell alone, which represents a cost of abatement of $888 per tonne, or almost 39 times the starting price of $23 per tonne $CO_{2\text{-}e}$ under the proposed CPM - an extraordinarily high figure.

8.4 Looked at another way, the move from a 'five star' to a 'six star' rating has added around $40 per square metre to the cost of constructing a new home. For a modest home (of 230 square metres), this has added $9200 to the build cost (CIE, 2010: 9), an expense which would have been passed-on to the new home buyer.

8.5 Taken together, the move from 'five star' to 'six star' energy efficiency requirements and the proposed CPM will add some $14,200 in nominal terms to the cost of new home by the middle of 2012.

8.6 Master Builders Recommend: the Federal Government compensate first home buyers for the expected cost of the CPM on residential housing by commensurate increases in the value of the First Home Owner Grant. This would mean a nominal value for the Grant of $ 12,000 in June Quarter 2012, with guaranteed indexation in line with movements in the price impact of the CPM.

8.7 The proposed CPM will add yet another layer of cost-burden on new home buyers and home renovators, and critically low-income renters.

8.8 This flow-on effect will follow as rental investors seek to claw-back from renters the likely increased cost of providing new rental accommodation, having a regressive impact on lower income earners who will receive no direct compensation.

8.9 The absence of a discrete compensation package for the residential building and construction industry (in contrast to arrangements made for other impacted sectors) will also add to the cost of housing, and thus impact adversely on housing affordability.

8.10 Master Builders is already on the public record expressing our concern: "*The compensation package may be adequate to cover increases in energy charges, but it will not cover the increase in the cost of new housing which will be at least $5,000 for a modest home with a $23 per tonne carbon price …"* (Harnisch, 2011).

8.11 Such an increase in new home prices will only add further pressure on (reducing) housing affordability, which is already difficult for many home buyers. It will compound the cost of living pressures many households already find themselves in.

8.12 Economic research has estimated the national housing affordability ratio (the median house price divided by median income) at 7.3 in March 2011 (that is, the median house price was 7.3 times median income in that period), well ahead of the ratio of 4.7 recorded a decade earlier (Natsem, 2011: 11).

8.12.1 A housing affordability ratio below 5.0 is regarded by Natsem as "affordable" while a ratio between 6.0 and 7.0 is seen to be "not affordable" and a ratio above 7.0 is considered "severely unaffordable" (Natsem, 2011: 5)

8.13 According to Natsem (2011: 11), housing affordability ratios were equal to or greater than 6.0 in all Australian capital cities in March 2011, ranging from 6.0 in Darwin and 6.2 in Canberra (both "not affordable"), to 7.7 for Adelaide, 7.9 for Melbourne and 8.4 for Sydney (well into the 'severely unaffordable" range).

8.14 While estimating the precise effects of the $ 5,000 cost-burden flowing from the imposition of the proposed CPM on housing affordability ratios is complicated (reflecting assumptions regarding interest rates and earnings profiles), there can be little doubt the added impost will only 'make a bad situation even worse'.

8.15 Master Builders will address two related issues – the fall in the real value of the First Home Owner Grant (down by almost 40 per cent by 2012, since its inception in 2001), and the rising real cost of the '6 star' system to impacted householders (likely to rise to nearly $9450 in 2012) – in our annual federal budget submission and related processes.

9 FLIGHT OF PRODUCTIVE CAPITAL

9.1 The introduction of a CPM ahead of, or more onerous than, our major trading partners brings with it considerable economic, commercial/industrial, and social risks.

9.2 The extent to which such an arrangement diminishes the competitiveness and the viability of Australian firms, whether directly or indirectly exposed to the CPM, brings with it additional incentives for productive capital to relocate to alternate locations.

9.2.1 Such alternate locations would include those countries without carbon taxation systems, or with more efficient, lesser cost and market-oriented CPMs.

9.3 In the current economic and commercial environment, such considerations are likely to weigh heavily on Australia's manufacturing industry, already concerned about the effects of a 'high' exchange rate on their capacity to compete in domestic and global markets.

9.4 This issue is particular important for the building material manufacturing industries – such as bricks, cement, glass, and steel, amongst others – which play an integral role in the building and construction sector, especially as providers of employment opportunities.

9.5 Such an impact could be seen in growing risk of one or both of two outcomes:

9.5.1 a relocation offshore of adversely impacted firms in the trade-sensitive building materials manufacturing industries, with attendant loss of investment and jobs; and/or

9.5.2 greater emphasis on import-substitution, through this diminishing the economic viability of the remaining building materials manufacturing firms, with an attendant loss of investment and jobs.

9.6 The Federal Government recognised the risk of 'capital flight' (which it labelled carbon leakage') when it said (SCEF, 2011: 53):

"*… applying constraints on carbon pollution in Australia before other countries could risk 'carbon leakage' – activities could be relocated from Australia to countries where those activities may not be subject to comparable carbon constraints."*

"Carbon leakage is not in Australia's interests – either from an environmental or an economic point of view. The Jobs and Competitiveness Program is designed to reduce this risk."

9.7 This risk of 'productive capital flight'/'carbon leakage' underpins the so-called 'shielding arrangements' under which higher emissions-intensive, trade-exposed activities will be given, inter alia, varying degrees of free allocation of emissions permits (SCEF, 2011: 54 - 56).

9.8 Master Builders Recommend: the Productivity Commission review the effectiveness of the 'Jobs and Competitiveness Program' in mitigating productive capital flight (or 'carbon leakage') in response to the imposition of the CPM. Such a term of reference should be in addition to those already prescribed (SCEF, 2011: 111) for the Productivity Commission for reviewing the 'Jobs and Competitiveness Program'.

10 GLOBAL BENCHMARKS ASSUMPTIONS

10.1 A key element of the Commonwealth Treasury modelling of the likely economic and commercial impacts of the proposed CPM is the benchmarking of the Australian Government's policy package with two international action scenarios.

10.2 These two international scenarios are: the medium global action scenario, which sees global action to stabilise GHG concentrations at around 550 parts per million (ppm) by 2100; and, an ambitious global action scenario, which sees global action to stabilise GHG concentrations at around 450 ppm by 2100.

10.3 These scenarios are seen to "*provide a credible and realistic backdrop to examine the impact of pricing carbon in Australia."* (SGLP, 2011: 2), and build on "*known information and assumptions of future developments"* (SGLP, 2011: 8).

10.4 Key amongst these assumptions are (i) countries and regions with emissions trading systems maintain them into the future and (ii) several regions take additional action in pursuing emissions reduction strategies (SGLP, 2011: 23).

10.5 Master Builders does not share this optimistic assessment of international commitment to global action. Rather, Master Builders sees a number of challenges as likely to impede such global action, most notably:

10.5.1 an outlook of sustained slow economic growth and rising unemployment in key developed economies (most notably the United States and Western Europe),

10.5.2 sizeable and deeply embedded fiscal imbalances, serious political impediments to public debt retrenchment and rising sovereign debt risk in many developed nations (even to the extent of existential risk for the European Union's single currency), and

10.5.3 a distinct reluctance in many developing countries to impose policy-settings which impair their economic growth and development.

10.6 Proposals for the World Trade Organisation's Doha Round of multilateral trade liberalisation (which would deliver tangible benefits to member nations) to be 'mothballed' are indicative of a stepping back from, rather than greater embrace of, bold global action on important policy matters.

10.7 Against this background, Master Builders regards the prospects for co-ordinated global action to achieve the outcomes set out in the two action scenarios used in the SCEF framework as less likely than that assumed by the Commonwealth Treasury in its modelling and forecasting (SGLP, 2011), with the more realistic scenario being at best 'standstill' on meaningful action.

10.8 Master Builders Recommend: The Commonwealth Treasury revise and reissue the modelling and forecasts undertaken for its SGLP report using a 'standstill' scenario for global action on GHG emissions.

11 SUPPLY OF PERMITS

11.1 A critical issue for Australian business will be the supply of tradeable emissions permits, if the proposed CPM enters into force.

11.2 Under the Federal Government's SCEF framework, there will be a two-step approach to the domestic supply of emission permits.

11.2.1 In the first step/phase, to operate from 1 July 2012, the price of permits will be fixed (initially at $23 per tonne $CO_{2\text{-}e}$, rising annually at 'inflation plus 2.5 per centage points'), with all demand for permits being met by necessary regulatory issuance – in essence, a 'regulated price/ permit quantity flexible' framework.

11.2.2 In the second step/phase, to operate for three years from 1 July 2015, the price of permits will be bounded (see following), but the supply of domestic permits will be regulated to meet the Federal Government's "*unconditional 5 per cent reduction (on 2000 levels) target by 2020…"* (SGLP, 2011: 48). In concrete terms, this abatement task amounts to some 159 million tonnes of $CO_{2\text{-}e}$ by 2020 (ibid).

11.2.3 During the second step/phase, a bounded pricing arrangement will see the imposition of price floors and ceilings. The price floor will be set at $15, increasing annually by 'inflation plus 4 per centage points', while the price ceiling will be $20 above the expected international price, increasing annually at 'inflation plus 5 per centage points'.

11.3 These regulated and bounded prices are likely to be above those prevailing in the international market place, and could lead to allegations of price manipulated by a future Australian Government.

11.3.1 In July 2011, the New Zealand Emissions Trading Scheme (ETS) saw market prices of $NZ22 ($A17) per tonne $CO_{2\text{-}e}$, while the European Union Allowance (EUA) spot price was just over $A16 per tonne $CO_{2\text{-}e}$ (KPMG, 2011: 5), well below the proposed $23 per tonne $CO_{2\text{-}e}$ slated to apply in Australia on 1 July 2012.

11.3.2 Over the longer term, carbon prices in Australia during the 'bounded price market' phase (after 1 July 2015) are likely to remain around the proposed price floor, rising gradually to $17.50 per tonne $CO_{2\text{-}e}$ in 2020, well below the $38 per tonne $CO_{2\text{-}e}$ predicted in the Commonwealth Treasury modelling for the same endpoint (Bloomberg, 2011).

11.4 An important issue for business, whether as direct purchasers of permits or indirectly as impacted purchasers of the goods and services of the primary purchasers, and for householders as consumers of those goods and services, will be how the domestic supply of permits is integrated into the overall emissions reduction objective.

11.5 Taken at face value, the '5% by 2020' objective implies a reduction of 159 million tonnes in permit-equivalents between 2012 (when the proposed CPM enters into operation) and 2020 (a milestone for the policy objective).

11.6 In the event a CPM proceeds in Australia, it is vital for business (whether direct or indirect users of permits) and householders to have certainty over the trajectory for the retrenchment of the domestic supply of permits.

11.6.1 For business, for investment and production decisions which involve inputs/outputs of materials containing carbon, and for the pricing of impacted inputs (including labour costs where these are linked to price indicators);

11.6.2 For householders, in managing their household accounts and balance sheets, and where they are employees in forming their remuneration expectations.

11.7 The Climate Change Authority will advise the Federal Government on the quantum, and other aspects, of these pollution caps (SCEF, 2011: 31), through regular public review and reporting processes, although the final decision on the quantum of the cap will reside with the Federal Government (SCEF, 2011: 27).

11.8 Clearly, the Australian Government will have substantial 'market power' as the monopoly supplier of domestic emissions permits. While liable businesses will be able to obtain permits/credits from other domestic sources or foreign sources, access to international permits will be regulation-limited.

11.9 In this situation, the Federal Government will play the (market-unhealthy) dual role of market player (as monopoly supplier of domestic permits) and regulator (sitting over the Climate Change Authority and the Clean Energy Regulator) – a situation incompatible with broader principles of national competition policy.

11.10 Under the SCEF, at least one-half (50 per cent) of a liable business' obligations must be met from domestic permits or credits (for example, from Carbon Framing Initiative (CFI) sources: SCEF 2011: 107).

11.10.1 If CFI-sourced credits account for 5 per cent of the 'pollution cap' (SCEF, 2011: 30), the Australian Government will have a protected market share of around 45 per cent of the tradeable permits.

11.11 Master Builders is concerned this dominant market power/ substantial market power could be manipulated to, for example, pursue revenue-maximisation or other public policy objectives.

11.12 Revenue maximisation: under this scenario, an Australian Government 'games the market' by reducing the domestic supply of permits to raise their price to 'strengthen' its fiscal balance sheet ('to raise more money').

11.13 This risk is accentuated by forecasts (Bloomberg, 2011)

11.13.1 carbon prices in Australia during the 'bounded price market' phase (after 1 July 2015) are likely to remain around the proposed price floor, rising gradually to $17.50 per tonne $CO_{2\text{-}e}$ in 2020, well below the $38 per tonne $CO_{2\text{-}e}$ predicted in the Commonwealth Treasury modelling,

11.13.2 which point to considerably less gross revenue for the Australian Government from the sale of permits, and related policy initiatives, than estimated in the Commonwealth Treasury analyses.

11.14 Other public policy objectives: under this scenario, an Australian Government uses the processes for the allocation of permits to achieve industry and/or regional adjustment/development policies

11.14.1 For example, allocating permits to firms willing to undertake major capital projects in preferred areas or penalise firms closing down production in favoured or politically sensitive areas.

11.15 Liberal access to international permits by liable entities will be important to minimise the potential for an Australian Government to 'game the market' as the monopoly originator of domestic permits, and/or use the permit allocation process for revenue-maximisation and/or other public policy permits.

11.16 As noted earlier (paragraph 5.5), a critical assumption of the Commonwealth Treasury modelling and forecasting of the economic and commercial impact of the proposed CPM is there will be "*unlimited international permits over the entire period"* (SGLP, 2011: iv).

11.17 Commonwealth Treasury usefully emphasises the importance of an efficient global market for permits: "*While pricing carbon cuts emissions, it is much more expensive to meet the whole abatement task domestically. Sourcing emissions reductions in other countries plays an important role, encouraging reduction in global emissions at the lowest economic cost. "(*SGLP, 2011: 7; see also SGLP, 2011: 83).

11.18 Axiomatically, the Federal Government's decision to limit international permits to no more than one-half of the supply of eligible permits/credits means the emissions abatement task is likely to be more expensive than would have been the case if liable entities were able to access a greater share – even up to 100 per cent – of their requirements from any appropriate source – domestic permits or credits, or international permits.

11.19 Master Builders Recommend: insofar as a CPM enters into force in Australia, liable entities have unfettered discretion as to where they source any required permits/credits, including up to 100 per cent of their requirements from international sources, without prejudice. This approach will facilitate the availability of permits/credits in the most efficient manner, at least cost, in deeper and more competitive markets.

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