National Farmers' Federation

House of Representatives Standing Committee on Environment, Recreation and Arts Inquiry into the Regulatory Arrangements for Trading in Greenhouse Gas Emissions

March 1998

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1. NFF Interest in Inquiry

The National Farmers' Federation, as the peak representative of the agricultural industry in Australia, welcomes the Committee's inquiry into emissions trading. Australian farmers and rural landowners have a significant interest in the possible medium term establishment of a domestic emissions trading (ET) scheme in Australia. This interest is heightened by the formal (though not complete*) recognition in the Kyoto Protocol to the Framework Convention on Climate Change and in Australia's own National Greenhouse Gas Inventory (NGGI) that carbon sink enhancements and other land use changes will be counted in calculating Australian performance against greenhouse gas abatement targets.

There are several, more specific, reasons for NFF's interest:

- carbon sink enhancements from revegetation stand to gain in economic value, as does the land being revegetated, and an ET scheme could therefore drive a more dynamic market for rural land

- at the same time, however, an ET scheme could *reduce* the value of cleared land if government required landowners without offsetting revegetation credits to acquire emission credits sufficient to cover expected emissions from proposed clearing*

- governments and the community in general are expected to take an increasing interest in the climate change implications of Australian land use, now that Australia faces an abatement target under the Protocol (assuming its ratification):

- significant efforts will be needed to achieve a 108% outcome by around 2010, and much of this additional effort may be expected by governments to come from agriculture, forestry and other land uses; there is therefore a risk that ET could operate or be designed so as to impose an inequitable share of national abatement efforts on agriculture, unless there is a robust scientific basis for measuring emissions, sinks and compliance across all economic sectors

- the design of any ET scheme could therefore affect the likely balance of advantage for rural landowners, and the equality of burden sharing among Australian industry sectors, and therefore NFF's ultimate position on ET.

* Despite some apparent support within the International Panel for Climate Change (IPCC) for recognising for sink enhancement purposes practices that would include periodic thinning of woody weeds and regrowth in northern Australia, neither the Kyoto Protocol nor the NGGI has yet recognised the sequestration value of this practice. This means that such thinning will *not* lead to abatement credits; rather, landowners may need to purchase ET credits if they wish to try to return their properties to their natural or prior state.

For these reasons, NFF particularly welcomes the inclusion in the inquiry's terms of reference of integrating sinks into any ET regime. The importance of sinks in Australia's efforts to achieve the Kyoto Protocol limit is apparent from the efforts still required to reduce national emissions to that 108% limit between 1990 and 2008-2012. The official prediction is that a 10% shortfall will *still* remain after the enhanced measures announced by the Prime Minister last November, which are expected to reduce to 18% the 28% "business -as-usual" growth estimate. This in turn was made *after* allowing for the significant abatement efforts under the voluntary Greenhouse Challenge program.

Achieving the further reduction to 108% is presumably expected to come from land use practices and any future measures (probably from State Governments) additional to the Commonwealth measures announced by the Prime Minister.

2. Emissions Trading in Principle: Benefits and Assumptions

ET schemes are assumed by many economists, including those at the Industry Commission, as having the potential to develop as the least cost economic instrument for achieving any given level of greenhouse abatement. They are regarded *potentially* as being more efficient and cost-effective than command-and-control regulation, and less negative or arbitrary in their impact than carbon taxes*. ET also leaves participants free to choose the best solutions and abatement measures for their own respective operations; thus facilitating a range of abatement options which will encourage permit trading and minimise marginal abatement costs.

If ET could be anticipated to operate as an efficient, market-based approach, it might have significant appeal to industry. To operate efficiently and equitably, however, a scheme would need several characteristics, among them:

- enough participants - permit holders - and industry sectors to maintain an adequate level of competition and a good level of trading, thereby increasing the range of cost-effective abatement options open to participants and therefore the marginal costs of abatement

- equal application to sink enhancements and probably to significant gases other than carbon dioxide (eg methane) provided accounting methodologies were reasonably robust and credible from the start of the scheme

- predictable, transparent trading rules

- reasonable transaction costs.

If, however, an ET scheme were developed without these characteristics, it could be just as inequitable or inefficient as a carbon tax or a command-and-control approach.

* See eg the Industry Commission's support for ET in its *Framework for Greenhouse Emissions Trading in Australia*, December 1998, pp 3-4. However, a poorly designed or administered ET scheme might prove less "efficient" than a carbon tax and just as unpopular with industry.

3. Emissions Trading Design Issues of Particular Concern to the Inquiry

Measuring, Verifying and Monitoring Emissions and Compliance

Credible and transparent processes for measuring, monitoring and verifying emissions (and sink enhancements) will be important to the environmental and commercial viability of an ET scheme. Accounting for carbon sequestration over the life of plantations, eg farm forests, is still being scientifically developed. If ET is to become a reality this decade, appropriately dependable and practical sequestration guidelines for common Australian conditions need to be determined as a priority, especially since the potential sequestration value of managed forests (if fully included in the NGGI) might exceed 25% of Australia's total emissions.

As the Industry Commission warns, complex reporting and verification processes will increase transaction costs and might dissuade smaller entities from trading. Participants with many smaller emission sources (eg farm equipment) would be at a relative disadvantage as regards transaction/compliance costs unless well accepted default measures were devised to easily estimate and aggregate such emissions.

Another example of how sequestration guidelines should operate practically and flexibly is for them to allow landowners the option to trade and hold credits just sufficient to cover any net emissions expected over the economic life of a land use operation *as averaged on an annual basis.* This could be an alternative to requiring credits to cover the ups and downs of annual changes as plantations develop from cleared land to vigorous then mature trees (and through several thinning stages).

Changes to methodology after a scheme commences could be both inequitable and commercially unsettling.

Integrating Emissions Trading with the Development of Carbon Sinks

Tradable carbon sink credits have a vital role to play in any ET scheme, especially in a country like Australia where "no regrets" sink enhancements have probably at least as much abatement potential as further no-regrets efforts from secondary, tertiary and household sectors.

As mentioned, land use improvements especially sink enhancements might be expected by governments to achieve up to half of Australia's net abatement in the next decade (after accounting for the Greenhouse Challenge Program). While noting the Industry Commission's caution that an ET scheme might best

be limited initially to the least complex and largest emission categories, all efforts should be undertaken to develop carbon accounting for sinks so that they can be incorporated in the initial design and operation of any ET scheme. This will ensure that large rural land holders (including possible cooperatives of smaller holders) are significant participants and traders, thereby increasing both the level of competition in the trading market and the number of low-cost abatement and sink options.

A further reason for including sink enhancement credits in a ET scheme is that revegetation already has attractive and multiple *non-carbon* benefits, with the result that ET participants will find revegetation and other improved land practices even more attractive when trading sink credits.

Allocating Rights to Emit

Allocation of rights must first be based on an achievable emissions target for the ET scheme. This in turn would presumably be based on achieving the Kyoto target (as reduced by the proportion of emissions from businesses not initially allocated emission permits).

Initial allocations to individual traders would need to be equitable. Any up-front payment requirement (eg with an auction system) is unlikely to be equitable, partly because the payment will hurt the cashflow of smaller would-be participants. While government may wish to set a threshold level - based eg on historic emissions per business - in order to limit the number of initial permit-holders, there will then be a subsequent problem for smaller firms which later need to buy credits above that threshold for their business expansion (eg, land clearing prior to new cropping).

Also, an ET scheme should not competitively disadvantage firms that had already achieved abatements through special measures such as actions under Greenhouse Challenge agreements that went well beyond “business-as-usual” measures.

There is the difficult issue of periodic downward reductions which governments might want to make to total permit allocations, reflecting the likelihood that nations will want to continue to reduce their emission caps. Any such reductions, and the timing of preceding reviews, should be signaled well in advance and preferably in the initial design of an ET scheme.

NFF presumes that credits under any new ET scheme would be limited to new and anthropogenic efforts to reduce emissions and enhance sinks.

We also presume that government agencies would need to become ET scheme participants if big enough to exceed any generally applicable thresholds for emissions or firm size.

Who Should be Able to Trade Emission Permits?

Despite the Industry Commission's cautious propensity to restrict initial trading to big energy-based emitters, there is a strong argument for extending a scheme to most sectors which are significant emitters or sinks for carbon dioxide.

As discussed, there is also the issue of how many traders would receive licences or who could subsequently acquire permits through trading. There is a risk that many of Australia's estimated 120,000 individual farmers and rural landowners might individually feel deterred from trading, because of transaction costs and insufficient trading influence on the level of prices in an ET scheme. This risk needs to be addressed, eg by facilitating the combination of smaller farm businesses into trading cooperatives.

Whatever mechanisms are identified and trialled, it will be important that an ET market not be dominated by a few large players, given the Industry Commission's warning about undue market power and control. Also, Australian agriculture should be given as broad opportunity as practical to benefit from incentives to develop greenhouse sinks and to reduce its emissions through improved land management.

Administration and Transaction Costs

Administration and transaction costs, if unreasonably high, could prejudice the efficient operation of an ET scheme. Any scheme must therefore be as straightforward and transparent as possible, minimising technical uncertainties over carbon accounting and the costs of any verification scheme needed to ensure the credibility of the scheme. Costs can be better contained the less government regulation accompanies an ET scheme.

Environmental and Economic Impacts of Emissions Trading

If emissions trading were likely to be the least cost option for achieving abatement sufficient to contribute to satisfy a 108% target by 2008-2012, its introduction might in fact be needed to help maintain Australian competitiveness. However, the costs of abatement would be needlessly high if an ET scheme were inadequately designed or imperfect in its operation; eg if the number of trades or traders, and therefore the extent of competition and range of cost-effective abatement options, were limited.

It is therefore vital for government agencies to continue research and design work on prospective ET models best suited to Australia's own circumstances, in close collaboration with industry including agriculture, forestry and other land-based sectors. For example, the issue of woody weed thinning or clearing in northern Australia needs careful consideration given that retention of this vegetation - despite its carbon sequestration effect - can choke both productive and habitat systems. Such special circumstances raise issues such as whether

periodic firing of woody weeds should be fully debited as solely an emission, without offset for consequent improvements in revegetation/regeneration

4. Other Issues

There at least two issues that do not fall neatly under the inquiry's terms of reference. First, as to the scope of an ET scheme, NFF notes the Industry Commission's concern that transaction costs could be unduly high if an ET scheme were complicated by extension to gases beyond carbon dioxide. As the Industry Commission concludes, "the challenge is to achieve an economic balance between the number of participants (and associated administrative costs), emission coverage and abatement opportunities" (December 1997, p.11).

Another issue that needs consideration is the tax treatment of gains and losses from emissions trading. Assuming capital gains tax is applicable under the law as it now stands, tax would be payable on the initial value of emission permits when allocated- if allocations are made free of cost for initial recipients (as recommended by NFF). This would be a very negative signal for voluntary participation in a new ET scheme. Rather, the cost base from which taxable gains or losses are measured should be based on the average of first round sales in the market.

5. Conclusions

NFF is very interested in the potential for emissions trading to both reduce net Australian emissions and to facilitate an important and beneficial role for Australian agriculture. However, our support for an ET scheme would be conditional on our becoming confident that it could deliver cost-effective abatement and sink enhancement, without damage to Australian competitiveness. Unless Australian agriculture and industry generally is confident that a domestic ET scheme could deliver those outcomes, without damage to Australian competitiveness, government risks getting too far ahead of the marketplace.

NFF support would also be subject to some other basic understandings such as:

- no carbon taxes
- full cost-benefit and regulatory impact studies for any ET proposal, in which industry would fully participate
- appropriate lead-time before any ET scheme were introduced (probably preceded by a trial)
- robust, science-based accounting for measuring carbon emissions and sequestration in many different circumstances.

A well designed and effective domestic scheme could be very useful experience before the introduction of any international scheme, including for Australian representatives in international design negotiations likely to emerge from the Kyoto Protocol.

NFF is pleased to participate in this inquiry, and would underline the important and mutually beneficial role that agriculture could play in national greenhouse abatement and in the design of equitable and efficient ET schemes involving comprehensive sink enhancement.

For further information about this submission and NFF views, please contact Anwen Lovett, Assistant Director for Environment at NFF on (02)6273 3855.