

7 April 2009

The Secretary
Senate Select Committee on Climate Policy
PO Box 6100
Parliament House
Canberra ACT 2600

Email: climate.sen@aph.gov.au

Dear Mr Hawkins

Rio Tinto is pleased to make a submission to the Senate Select Committee on Climate Policy. No part of this submission is confidential. Rio Tinto intends to make a further detailed submission on the legislation as part of the CPRS legislative review due on 14 April.

Rio Tinto has generally restricted commentary to current government policy initiatives namely the emissions trading scheme (Carbon Pollution Reduction Scheme) and the 20% Renewable Energy Target. Consequently, this submission includes discussion on points on some items over which there is still uncertainty for Rio Tinto. This highlights a more general point – namely, the gap between best practice regulatory policy development and the current accelerated legislative drafting, data gathering and consultation processes. The Government should be prepared to relax its schedule to give time for development and testing of a well designed problem-free scheme.

Over the past 12 months, Rio Tinto has worked constructively with the Government and the Department of Climate Change on the development of an emissions trading scheme appropriate to Australia, Australian businesses and the current challenging economic environment. The Group has made detailed and publicly available submissions on many of the Government's climate related papers and the Garnaut review – to which the Senate Committee is also referred. While Rio Tinto acknowledges the policy progress in 2008, the scheme – as detailed in the draft legislation – will have a significant adverse impact on our Australian operations.

The costs to Rio Tinto of the proposed scheme rise through time from \$130 million¹ in 2010/2011. These costs are mainly borne by Rio Tinto's aluminium smelting, alumina refining, coal and iron ore businesses. Being trade-exposed with major competitors not subject to a carbon price, our businesses will not be able either to pass through these higher costs to our customers or to absorb such an impost in today's difficult economic environment. Rio Tinto's analysis also shows some coal mines that were considered "long life" would close around 2020 under the CPRS². Put simply, the CPRS, as proposed, will cost jobs – now and in the future. However, the environmental benefits depend upon collective international actions.

¹ The calculation basis of impacts is described in the Supplement to this document.

² These conclusions are based on: (1) Rio Tinto's internal modelling of the scheme's financial impact; and (2) the broader functionality of the scheme to reduce global emissions.

Rio Tinto supports the use of properly designed market based mechanisms to address the climate imperative but believes that two issues are paramount from a national perspective:

- the need to ensure that the scheme is designed to take full account that Australia will be introducing a carbon price on key trade-exposed industries well in advance of our major competitors and with great uncertainty surrounding a future global climate change agreement covering the world's major emitting nations. Carbon leakage is an acute concern for Rio Tinto's Australian existing and prospective operations as the majority of our competitors are located in non-Annex B countries; and
- a recognition that in the midst of a severe economic downturn (potentially the deepest global recession in the post-war years) there is no margin for error in scheme design and implementation.

Rio Tinto has seven key issues that need to be resolved prior to the introduction of the scheme:

1. EITE Activities – Allocation Erosion - The 1.3 per cent erosion of permit allocation to EITE industries will progressively and significantly reduce the competitiveness of Australian trade exposed businesses. Efficient industries will suffer the double impact of the initial cost of the scheme and a continued worsening in their competitive position in global markets. Permit decay increases the negative impact on Rio Tinto's aluminium smelting, alumina refining and pig iron smelting EITE industries by a cumulative operating cost of around \$430 million over the first decade of the scheme. For alumina refining and aluminium smelting it constitutes 20 percent of the costs under the scheme in the period until 2020. As we said in our submission to the Green Paper and subsequently, in order to avoid serious impacts on export competitiveness, all EITE activities should maintain their initial percentage allocation of permits (ie 60 percent and 90 percent) until 80 percent of all carbon emissions globally are covered by a comparable carbon constraint.
2. EITE Activities – Alumina - The initial EITE permit allocation rate for alumina businesses remains uncertain. Alumina production is a key value adding export industry for Australia and a source of high-wage, value-added jobs. The refining industry's current estimate, based on reasonable and measured emissions-intensity information, suggests that alumina secures 90 percent permit allocation. However, results of the EITE allocation process remain uncertain and open to some discretion. While Rio Tinto considers Australia to be a world-class location for future alumina refining, it is simply uneconomic to invest in new facilities without an assured ongoing 90 percent EITE permit allocation. Recent policy developments in the US and Europe suggest alumina will receive the highest level of allocation highlighting the risk of policy disparity and associated market distortion for the Australian alumina industry, if alumina does not receive 90%. The costs of getting the allocations wrong, due to some quirk of activity definitions or the application of excessive uncertainty bands associated with retrospectively-prepared eligibility data, are great. They would force onto Rio Tinto's alumina assets additional cumulative operating costs in excess of \$1 billion over the first decade of the scheme. Such an impost would thwart any reasonable prospect of growth in alumina refining in Australia and adversely affect profitability of existing operations. Greater certainty needs to be provided to ensure this does not occur.

3. Coal - The inconsistent treatment of the coal industry needs to be addressed. Under the Government's own definition, coal mining qualifies for 60 percent EITE permit allocation. It should be accorded this status, instead of an inadequate and short lived "compensation package". According to our analysis, some Rio Tinto coal mines that are "long life" would close around 2020 under the scheme due to this treatment and the delays on coal seam methane measurement matters. Any reduction in Australian coal exports will be taken up by competitors in countries without comparable climate policy, negating environmental benefits.
4. Technology development and deployment - Current EITE allocations discourage low emissions technology development and demonstration in Australia. An *Innovation in Climate Change* package that is intimately linked to the scheme to ensure no unintended consequences is required to ensure Australia continues to develop and deploy low carbon technologies such as Rio Tinto's HIs melt[®].
5. Renewable energy target - Government climate policy does not take account of the additional and cumulative impact of the RET. The RET will almost double the cost of climate policy to the aluminium smelting industry – adding around \$600 million dollars to Rio Tinto's smelting electricity usage costs over the first decade. Renewable Affected Trade Exposed (RATE) industries should be given a full exemption from the current and expanded RET until 80 per cent of all emissions globally are covered by climate policies comparable with Australia's. The combination of the CPRS and RET will not reduce greenhouse gas emissions at least cost.
6. Scheme implementation - Rio Tinto has consistently advocated that the early years of the emissions trading scheme need appropriate checks and balances to prevent unintended consequences. This is even more important in the current economic environment to strengthen business confidence and to reduce the loss of jobs in Australia. The scheme must have a measured, 'soft' or even a deferred start – and the Government needs to move early to reassure businesses of this. The most effective means by which this can be done is through a price cap rising from \$10 per tonne CO₂-e. This takes account of the sharp deterioration in the global economic outlook since the White Paper release. Phase 1 of the EU ETS provides justification for a 'soft' start.
7. Large User Electricity Contract Renegotiation – The Government is proposing a sensible solution to a most serious risk to large electricity users. However, the government has not allowed sufficient time for commercial power contract renegotiations – especially if the passage of the legislative instruments through parliament is delayed.

The above points outline the key messages Rio Tinto wishes to register with the Senate Committee. Further detail is contained in the attached Supplement including certain tax considerations.

Rio Tinto appreciates the diverse interests and multiple objectives that confront policy-makers in designing the CPRS. We support a balanced approach where the burden of reducing Australia's emissions is shared across the community. It is crucial, however, that the policy framework is geared towards wealth creation, not the distribution of revenues drawn from Australia's most efficient industries. No country can tackle climate change from a position of economic weakness. Similarly no regime of household assistance can compensate for the economic insecurity that flows from declining export

competitiveness and loss of investment and jobs overseas for no environmental gain. Without the additional actions proposed in this submission, Rio Tinto believes that the CPRS has the potential to undermine Australia's economic growth to the detriment of the nation as a whole, not least those who rely on a strong mining sector.

Yours sincerely

A handwritten signature in black ink that reads "Stephen Creese". The signature is written in a cursive, flowing style.

Stephen Creese

Supplement to Rio Tinto's Submission to the Senate Select Committee on Climate Policy

Emissions Intense and Trade Exposed (EITE) Activities

Rio Tinto conducts five activities that the Government is likely to deem as EITE-qualifying activities – aluminium, alumina, alumina hydrate, lime and pig iron production. This leaves the majority of Rio Tinto's exports (iron ore, coal, bauxite, salt, uranium, diamonds, copper and talc) with no permit allocations and bearing an additional cost of around \$1.5 billion over the first decade of the scheme - impacting both Australian competitiveness and growth potential. (On any reasonable analysis, coal should qualify for 60 percent allocation – see below).

A key problem surrounds permit decay and the proposed 1.3 percent annual decline in EITE permit allocations. Justification for the proposed decay is based upon assumed efficiency improvements within EITE activities. For already efficient industries, such as Australia's aluminium smelters, incremental improvements in both direct and indirect emissions are increasingly hard to achieve. However, even if theoretically achievable they will only be achieved through additional real costs in terms of CAPEX incurred that have not been considered by government. Accordingly, Rio Tinto continues to maintain its position that there should be no permit decay until 80 percent of all emissions globally are subject to comparable carbon policies.

Rio Tinto remains concerned that various issues of the EITE eligibility and allocation process do not follow best practice regulatory practice. These issues are compounded by the Government's timeline. The process for surrounding treatment of EITE:

- Is insufficiently comprehensive. There are significant CPRS costs that will be seen by EITE industries which are not considered in the determination of eligibility or allocation. For example:
 - Parts of the production process have been removed from the DCC activity definitions but still require permits.
 - Costs such as those associated with the fugitive emissions from natural gas will be passed through the supply chain but are only considered for users of natural gas as a feedstock. The costs are as real for other users of gas.
- Is being conducted against a limited set of baseline years. The baseline years include one of the greatest resource booms in Australia's history. The choice of years will materially affect the result.
- Is out of synchronisation with parliamentary review and potentially prejudicial to industry. If there are any changes to the Bill and Regulations as a result of the parliamentary review, the very significant cost required to assure the numbers could be used as a reason not to revisit various aspects of the eligibility process as these costs are being incurred ahead of legislation or regulation.
- Requires an industry average. Inherently this holds all the participants hostage to the whole industry submitting quality assured data at the same time. If any particular participant will not, or because of difficult financial circumstances cannot, submit assured data in a reasonable timeframe, this will be to the material disadvantage of the entire industry.
- Is arbitrary, as demonstrated by the movement in the EITE eligibility thresholds between the Green paper and the White paper. But again, once activities are determined to be 60 or 90 percent in the draft regulations, to change the thresholds will be difficult.

Further, the Government needs to define better:

- the criteria and provisions for the termination of EITE permit allocation;
- the terms of reference for the five yearly reviews of EITE assistance;

- additional concessional treatments for low emissions technology development plants with unique issues related to the impacts of technological uncertainty on production ramp-up profiles and ensuing poor emissions intensity in early years;
- emissions intense trade exposed activity definitions so as not to exclude essential parts of the process or otherwise reduce needed allocations; and
- the criteria that would initiate more frequent scheme reviews (all of which are related to international developments).

Rio Tinto notes and supports recent announcements, including the establishment of the Trans-Tasman Officials Group, by the Government to align where possible the CPRS with the New Zealand emissions trading scheme. This is a small step towards international policy alignment and one which is important to Rio Tinto whose aluminium business also operates in New Zealand. Indeed, in our submission to the New Zealand Emissions Trading Scheme Review Committee on 13 February we suggested alignment in the treatment of EITE industries in the two schemes.

Coal

The Government singles out the coal industry for inadequate treatment relative to its EITE peers. Although the Australian coal industry meets the 1000t CO₂-e/\$M revenue threshold for 60 percent EITE allocation, it will receive no permits. Instead, it qualifies for a \$750 million adjustment package over five years - an offer equivalent to approximately 15 percent of permit needs for the five year period. The package does not recognise the vital role coal plays in maintaining secure power supply globally or as Australia's leading export earner. Investment timelines for the coal industry are measured in decades so a five year package does not mitigate the disincentive to continue to invest in the Australian coal industry. Unlike EITE activities, allocations will not apply according to production in the sector. Two-thirds of the proposed assistance will go to a limited number of the gassiest under-ground mines.

Of particular concern is the premature inclusion of fugitive emissions from coal mining within the scope of the CPRS. Contrary to claims made in the CPRS White Paper, abatement technologies are not readily available. No other operating or proposed emissions trading scheme in the world currently includes fugitive emissions from coal mining. Adequate methodologies describing how to measure fugitive emissions from coal mines do not exist. The NGERs guidelines for direct measurement, while a good start are not sufficiently robust to establish clear auditable methods, particularly with respect to sampling requirements determining what the liability of an open cut mine could be from fugitive emissions. The only alternative for open cut mines is to use default fugitive emission factors which can be incorrect by a factor of ten or more, and act effectively as a tax on production. Transitional arrangements are required to support the development of robust methodologies to assess fugitive emissions from coal mines to an auditable standard. They are also needed to allow the assessment and further development of abatement technologies before fugitive emissions are included within the scope of the CPRS.

The government has justified not extending to the Australian coal industry the same allocation afforded to other EITE industries due to the skewed distribution in methane emissions across Australian coal mines. If the Government were to adapt its own preferred allocation methodology (i.e. allocate permits equal to each mine's historic emissions intensity), this would remove any windfall gain risk.

Rio Tinto's mines do not qualify for anything approaching adequate assistance in spite of contributing between 10–15 percent of Australian coal production. Using Rio Tinto investment criteria and a carbon price similar to the Treasury's CPRS-5, half of Rio Tinto's open cut coal mines would be likely to close around 2020.

Technology Development and Deployment

During technology development and first-of-a-kind deployment, the current allocation methodology for EITE industries is not appropriate. Specifically, the CPRS will act as a

disincentive to low emissions technology demonstration in Australia by not taking account of higher than 'design' emissions during the ramp up to an industrial scale demonstration plant and because of the lag in permit allocations.

The HIs melt[®] Kwinana plant is currently on care and maintenance due to the very low world pig iron prices. Additional costs will make recommencement harder. Prior to shut down, it had been reaching close to nameplate productivity levels with emissions intensities continuing to fall and improving plant reliability. Rio Tinto believes that in addition to fair EITE allocations for pig iron production, assistance over a number of years should be provided to encourage technology development and deployment via an *Innovation in Climate Change* package that would take account of emissions associated with ramp-up and testing regime of a first of a kind demonstration. This would apply not only to HIs melt[®], but also to clean coal technologies as they are developed and initially deployed. Failure to consider the special circumstances of emergent low emission technologies could serve to damage Australia's climate change credentials and result in a failure to capitalise on our abundant intellectual resources and capacity to encourage and support global action.

Renewable Energy Target

The RET measure has overlapping impacts with the CPRS. This overlap could cost Rio Tinto's aluminium smelting and alumina refining assets an additional \$600 million in the decade to 2020. These costs are additional to any carbon costs and policy induced increased electricity, transmission and reliability charges. The Government to date has not adequately recognised these impacts on RATE industries from the RET.

RATE-qualifying activities (those exceeding 4000 MWhr/\$m revenue) should be exempted from the current and expanded Renewable Energy Targets until 80 percent of all emissions globally are covered by comparable climate schemes. There are domestic and international precedents for such an approach. Additionally, the shortfall charge should be reduced from \$40/Renweable Energy Certificate (REC) on 1 July 2010 to acknowledge the interaction between the RET and CPRS. Even with these needs addressed, Rio Tinto's liable alumina, iron ore, coal and copper businesses would still face higher costs from the RET.

Scheme Implementation

Since the release of the White Paper, the severity of the global economic downturn and the impact it will have on companies in the lead up to emissions trading has become more apparent. Commodity prices have collapsed. Companies, including Rio Tinto, have announced job and production cuts. These developments reinforce a point that Rio Tinto has made consistently over the last 12 months – the scheme must have a 'soft' or deferred start, and the Government needs to move early to reassure investors of this. At present across Australia business solvency risk is at record levels. Additional costs associated with the CPRS will impact individual businesses potentially forcing permanent shut downs and job losses. New substantial costs should be only introduced when business conditions return to the more customary business cycle.

Rio Tinto has consistently advocated appropriate checks and balances in the early years to prevent unintended consequences. It is important to remember that, under the Government's proposed schedule, by 2010 Europe, Australia and New Zealand will likely remain the only regions where there will be effective schemes in place (whilst most of our competitors are located in other regions). It should further be acknowledged that the EU ETS scheme in phases 1, 2 and 3 (out to 2020) is, in terms of coverage and auctioning, more modest than that being proposed for Australia and also that introduction of the EU ETS has had its issues.

There are various ways in which a soft or deferred start to the scheme can be promoted. Notwithstanding this, Rio Tinto's analysis indicates it is essential that such measures do not detract or are used as a decoy from correcting poorly designed features in the current scheme – that is, good scheme design is of paramount long term importance. Rio Tinto's focus is on a sustainable scheme design with recognition of the effect the current economic environment is having on short run cash availability.

Market and carbon price behaviour in the initial start-up years of the scheme remains a black box that is poorly described by Government documents. Unexpected and perverse start-up consequences could have major adverse impacts on the Australian economy. A much more coherent understanding of scheme start-up conditions is required and increased flexibility must be built into the scheme if outcomes are outside of expected government CPI, balance of trade and employment parameters.

The simplest and most effective approach to ensure a soft or deferred start to the scheme in light of the sharp deterioration in economic conditions, globally and in Australia, is to set a lower price cap in the scheme's early years, one that takes account of the state of the Australian economy. The current proposal is for a transitional cap on the price of permits of \$40 per tonne at scheme commencement, rising at five percent plus CPI per annum. Such a price would be unaffordable to Rio Tinto businesses under current commodity prices and would result in business contraction and consequential job losses. Rio Tinto believes a more economically responsible approach to preserve economic activity and jobs in Australia in coming years would be to make \$10 per tonne the initial price cap, rising at five percent per annum. Rather than set an arbitrary point for the lifting of the cap, this should be linked explicitly to sustained economic recovery in Australia based on appropriate criteria (for example, a restoration of employment in the economy at 2008 levels). Such an approach would provide greater certainty and confidence to business and to the general community about Australia's capacity to accommodate what will still be an enormous economic adjustment task under the scheme.

Large User Electricity Contract Renegotiation

In determining the electricity allocation factor, the Government has set out a 'large user clause' (White Paper Policy Position 12.14) which recognises a most severe risk to large electricity users. The risk to users, such as aluminium smelters, lies in providing a single national electricity allocation factor without regard to the actual price uplift from the contractual arrangements. The White paper also sets out an alternative and sensible means to manage this issue. This alternative revolves around very large electricity users and their suppliers renegotiating electricity related carbon pricing terms in their supply contracts in light of the CPRS. Doing so would trigger a move to the national allocation factor of 1.0 t CO₂-e/MWh. The 'large user clause' would not apply, provided this renegotiation was completed before 1 January 2010.

Even in optimum circumstances large users and their suppliers will require at least six months to complete any renegotiations following successful passage of the legislation and regulations through parliament. The current uncertainty in the Australian electricity sector as a result of climate policy further compounds these challenges. Should the passage of the legislation be delayed in any way, the timeline of 1 January 2010 to initiate the large user clause and end the window for renegotiation is unreasonable and should be extended.

Tax

Rio Tinto supports the Government's intention to introduce discrete tax legislation that should not distort taxpayer behaviour. In this regard, the draft tax legislation needs altering to allow greater flexibility of choice for tax consolidated groups and liable entities interacting with multiple joint ventures. For example, one taxpayer may be the liable entity for multiple facilities and will be required to negotiate various individual commercial approaches to permit management with every non-controlling participant in each of those facilities.

The single choice of either market value or cost valuation method that exists in the current draft bill does not grant the taxpayer the flexibility of approach which will be required from a practical perspective. Furthermore, should the taxpayer value permits under the cost method, valuing all permits with the same vintage year on a first-in first-out basis, does not recognise the commercial reality that one liable entity may have multiple bundles of permits, which it will be required to manage on behalf of various individual facilities with different emissions profiles.

Reiterating our previous submissions, Rio Tinto strongly encourages the Federal and State governments to reach agreement that State governments will not include permits in their tax base in any way.

Comments on Rio Tinto's calculation of financial impacts

- Rio Tinto's business decision making is based on its own internal assessments of likely carbon prices. The figures have been generated using values consistent with Government modelling where possible
- Unless otherwise indicated figures are pre-tax on a Rio Tinto equity share basis, in 2009 Australian dollars using carbon prices similar to those from Treasury modelling for CPRS-5. Permit allocation is based on the White Paper and estimates of industry average emission factors eg based on Australian Aluminium Council Sustainability Reports. Renewable Energy Target REC prices are those used in the MMA modelling, as is the projected Australian electricity demand. The cumulative costs presented are for the decade 2010-2020 and are not discounted.
- 2010 / 2011 costs (on Page 1) are based on actual 2008 calendar year emissions and A\$25 per tonne CO₂-e permit price together with 90 percent EITE permit allocations for EITE eligible activities.
- The cost to non-EITE eligible businesses over the first decade of the scheme (P4) is for 100% share of Rio Tinto managed businesses.
- **Note:** should the carbon price actually be higher than those used, ie closer to the \$40 per tonne CO₂-e price cap, the imposts on Rio Tinto will be proportionately higher. If Joint Venture partners were included, these costs would also be substantially higher. Use of 2009 Australian dollars is consistent with values presented in the White Paper. In the calculations no consideration has been given to additional costs associated with Scope 3 (other indirect) emissions. These will be substantial.