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CLEANER GLOBAL CONTRIBUTOR

A PROPOSAL TO OPERATIONALISE THE MECHANISM WITHIN THE AUSTRALIAN EMISSIONS TRADING SCHEME

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IN A NUTSHELL ...

There is a global environmental benefit to encouraging the expansion of the natural gas industry, including 'cleaner global contributors' like Australian Liquefied Natural Gas (LNG).

In the transition to a lower-carbon world, Australian LNG offers a unique opportunity for Australia – both for growing our domestic economy and growing our potential to contribute to reducing global emissions. It is, therefore, in Australia's best interest to foster LNG as a national strategic asset and as an integral part of the global solution to climate change.

The scale of prospective investment in Australian LNG development is already significant but is embryonic compared to its potential. Total existing, committed and proposed Australian LNG projects represent a capacity for nearly 100 million tonnes of LNG per annum (compared to 20 mtpa at present) and an estimated capital investment of around $200 billion (in net present value terms).

Achieving this potential will bring with it economic growth; and export, employment and government revenue benefits, while providing diversity to Australia's energy economy with increased penetration of gas in the domestic manufacturing industry and a major boost to remote regional economies particularly in Western Australia, Queensland and the Northern Territory.

Constraining Australia's LNG industry will ultimately lead to higher global emissions.

The mechanisms proposed in the Green Paper to deal with trade-exposed industries 'decay' rapidly over time. They are therefore unsuitable for the highly capital intensive LNG industry where many growth projects will not commence production until 2015 to 2020 and the 'break even' return on capital will take many years to generate. In addition, the tax depreciation schedule in Australia, at 15-20 years, is uncompetitive compared to many overseas investment destinations.

APPEA is therefore proposing a complementary mechanism to capture LNG within the scheme as a cleaner global contributor. The proposed mechanism could encompass the following criteria to assess cleaner global contributor activities and therefore determine eligibility:

1. ***Global contributor***: emissions reduced globally as a consequence of the product are more than the associated emissions produced in Australia;
2. ***Global sustainability***: industry would expand under a global carbon price;
3. ***Affordability***: economic benefit to Australia through additional taxation revenue associated with the industry's expansion would exceed the cost to Government; and
4. ***Trade exposed***: capacity for passing through costs is restricted as a consequence of both competitor advantages and the substitutability of cheaper alternatives in the absence of a global carbon price.

A cleaner global contributor mechanism would offset international competitive disadvantage through the grant of permits representing the total of their direct and indirect emissions. Other measures of corresponding value could also be considered as a means for delivering a 'no net cost' outcome.

APPEA submits that the cleaner global contributor mechanism would be transitional, continuing only until international competitors and customers face comparable imposts on emissions.

1. RATIONALE FOR TREATMENT AS A CLEANER GLOBAL CONTRIBUTOR

There is a global environmental benefit to encouraging the expansion of the natural gas industry, including 'cleaner global contributors' like Australian Liquefied Natural Gas (LNG). For optimal global environmental outcomes, the Australian Carbon Pollution Reduction Scheme (CPRS) needs to recognise the potential of Australia's vast reserves of natural gas in addressing national and international greenhouse gas emission targets.

In the transition to a lower-carbon world, Australia's natural gas in the form of LNG offers a unique opportunity for Australia for growing our domestic economy and growing our potential to contribute to reducing global emissions. This is because, when used for electricity generation, natural gas produces 50-70 per cent less greenhouse gas emissions than coal. Australia's vast gas reserves – the envy of many developed countries – makes us very well positioned to foster LNG as an integral part of the global solution to climate change. LNG is a 'cleaner global contributor'.

Potential emission reductions overseas considerably exceed the emissions associated with the production of LNG in Australia[1] and this contribution can grow substantially in coming decades. Tangible recognition of this net positive reality and potential can be efficiently accommodated within the CPRS.

The Green Paper notes "*trade-exposed industries may not be able to pass on the costs as they face prices set in international markets, and compete against firms that do not at this stage have comparable carbon constraints*". The *Carbon Pollution Reduction Scheme Green Paper*[2] handles this issue through the creation of an emissions-intensive trade-exposed (EITE) category. For a variety of reasons, primarily associated with the massively capital intensive nature of the LNG industry and the large sums of up-front costs involved in LNG projects, the EITE category is not relevant to LNG industry[3]. This category, nor the draft CPRS more broadly, does not take account those industries that would deliver a substantial net benefit to the world's environment and that would expand under a global carbon price.

LNG is one of the industries or activities that would be viable in a world of uniform global carbon pricing. If the real prospect of huge and imminent investment in this industry in Australia is inhibited, the loss will be incurred across the Australian economy and it will have been incurred for no sound reason, either economic or environmental.

The main "economic" argument that has been advanced to restrict support to emissions intensive activities (defined on an arbitrary revenue or value added metric) is that wider support would be at someone else's expense. APPEA is

[1] CSIRO (1996), *Lifecycle emissions and energy analysis of LNG, oil and coal*, December; WorleyParsons (2008), *Greenhouse Gas Emissions Study of Australian LNG*, July.
[2] *Carbon Pollution Reduction Scheme Green Paper*, Commonwealth of Australia, 2008 (see www.climatechange.gov.au/emissionstrading/index.html).
[3] The greenhouse gas emissions intensity of the North West Shelf project, for example, is below 1,500 tonnes/$m using either revenue or value added as the ratio's denominator, even when not counting revenues from all products other than LNG. 1,500 tonnes/$m is the lower support threshold proposed in the Green Paper.

proposing a criterion for treatment as a cleaner global contributor that would obviate this concern.

Environmentally, any curtailment of the growth in Australia's LNG output would be unequivocally negative. Global greenhouse gas emissions would be higher – near-term and, conceivably, long-term as well.

2. THE APPEA INITIATIVE AND THE TREATMENT PROPOSED

The proposal in this paper is an initiative of APPEA as the industry association representing the Australian upstream oil and gas industry, including the LNG industry. There should, however, be no suggestion that it is tailored exclusively for LNG. Other industries may well have comparable cleaner global contributor claims and, if so, APPEA supports identical treatment, with identical criteria for eligibility.

The nature of the offset proposed to be provided to industries or activities that satisfy the criteria would be a credit against permit obligations, with the quantum of credit being limited to a firm's, or an activity's, total emissions. The competitive disadvantage faced in any such instance is equal to the cost imposed by the emissions trading scheme, so in order to offset that disadvantage it is appropriate that the credit equals 100 per cent of relevant emissions.

3. FOUR CRITERIA FOR ELIGIBILITY

To safeguard the interests of the Australian community, APPEA's proposal envisages four criteria for eligibility as a 'cleaner global contributor':

1. ***Global contributor***: emissions reduced globally as a consequence of the product are more than the associated emissions produced in Australia;
2. ***Global sustainability****:* industry would expand under a global carbon price;
3. ***Affordability***: the direct and indirect economic benefit to Australia through additional taxation revenue associated with the industry's expansion would exceed the cost of the measure to Government; and
4. ***Trade exposed***: capacity for passing through costs is restricted as a consequence of both competitor advantages and the substitutability of cheaper alternatives in the absence of a global carbon price.

Satisfying the criteria would entitle the industry or activity to the full competitive disadvantage offset outlined above. The proposed criteria are described below.

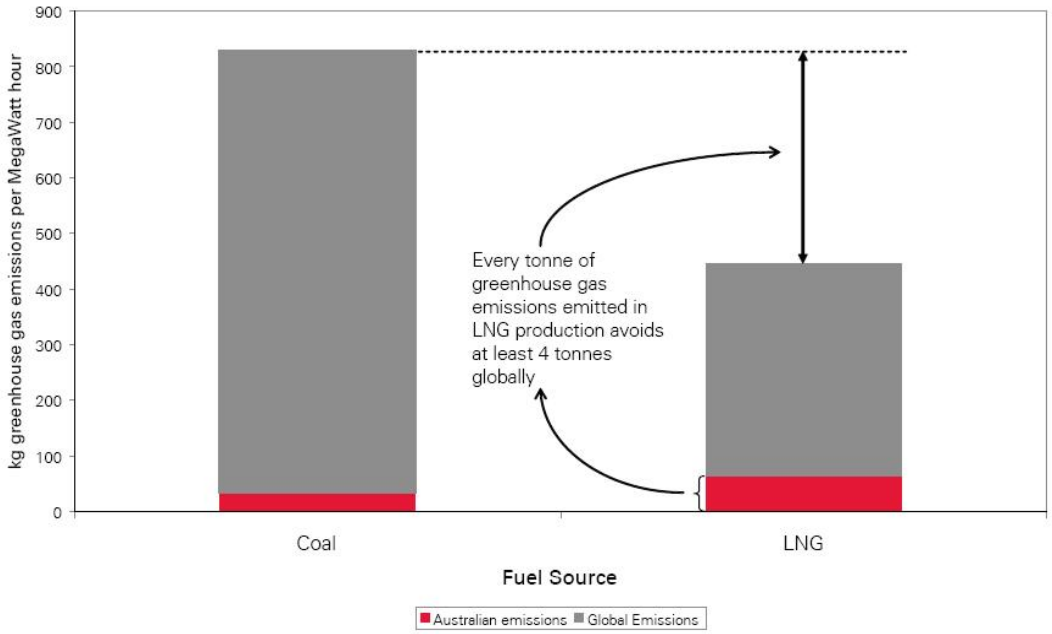
3.1 Global contributor

The global contributor criterion addresses the core of the cleaner global contributor concept – that while activity in Australia increases Australian emissions, its end result is a substantial reduction in emissions overall, since attributable abatement overseas outweighs the domestic emissions involved in enabling that abatement.

To dispel one potential misconception immediately, APPEA and the LNG industry is not suggesting it be credited for the full net benefit of the global contribution[4] – only to a maximum of the related Australian emissions which, for LNG, is a fraction of the global emissions benefit.

The following chart illustrates the point.

Chart 1: Comparison of Life Cycle Greenhouse Gas Emissions for Australian LNG and Australian black coal exports



Source: CSIRO.

It shows that for every tonne of greenhouse gas emitted in the production of Australian LNG, at least four tonnes (in the case of Japan or between five and nine tonnes in the case of China) of greenhouse gas emissions in customer countries are avoided when LNG is used to displace coal-fired power generation. Reductions are multiplied where LNG displaces other higher emission fuels, for power generation or industrial processes.

The important policy issue is that there should be no additional impediment to the development of industries like LNG that offer so much to this country's economic prospects and, at the same time, affords one of Australia's greatest potential contributions to global emissions abatement particularly in the short to medium term. These industries, the cleaner global contributors, are the industries of a carbon-constrained future and the treatment in a 'go it alone' CPRS needs to reflect that.

3.2 Global sustainability

This criterion – 'global sustainability' – identifies industries that would be at least viable but most likely expand in a world of uniform global carbon pricing. The criterion would involve the application of economic models of exactly the

[4] As Canada did in the UNFCC and Kyoto Protocol negotiations, see UNFCCC Document Number FCCC/SBSTA/2002/MISC.3/Add.1.

same type – though with some further granularity[5] – as those being used by the Treasury to allow the Government to determine national emissions trajectories.

In addition, the Green Paper listed as one of its three key rationales in this area, to *"support production and investment decisions that would be consistent with a global carbon constraint"*. This criterion is consistent with the Green Paper's rationale.

3.3 Affordability

As noted above, APPEA is not proposing the 'cleaner global contributor' mechanism as a superior substitute for the proposals of the Green Paper. It could equally be a complement, recognising that industries like LNG, for which treatment is warranted, are not readily accommodated within the existing framework. Such an outcome always prompts the issue of cost: the proposition that offset provided to one industry must be at the expense of another. APPEA has identified an alternative approach to the issue to address this concern.

This alternative is directly pertinent to potential growth industries, like LNG, in which an inventory of new investment projects at differing stages of readiness exists awaiting 'final investment decision'. These projects will proceed, and proceed to pay taxes (as well as lenders, suppliers, employees and shareholders), or they will not proceed and not pay taxes. Economic modelling done by Concept Economics drawing on the Access Economics GE model shows that under the draft CPRS, LNG growth would be constrained by 16, 26 or 37 per cent (depending on the emission reduction trajectory taken to 2020 on the way through to a 60 per cent reduction by 2050)[6]. This modelling has been made available to Government.

This concept prompts a third criterion, 'affordability', by which the taxation revenue from the value of the otherwise industry contraction, as modelled, would at least offset the cost of the necessary permits or credits[7]. By this proposal, government can be assured of the wherewithal to fund permits/offsets and the question of "at whose expense?" should not arise. Access Economics is currently developing a paper on "the Business Case for Competitive Disadvantage Offsets" which will be forwarded to Government once complete.

3.4 Trade exposure

There is only one efficiency reason why the CPRS should incorporate treatment for industries facing a carbon cost not borne by its competitors and customers. This is that they are unable to pass through the additional cost to their customers.

[5] Although the Treasury's global model does not disaggregate LNG from the oil and gas industry, at least one other comparable model, the Access Economics AE-RGEM model, does so. Treasury's model is capable of being similarly disaggregated.

[6] Concept Economics (2008), *Estimated Impact of the Proposed Domestic Emissions Trading Scheme on the Oil and Gas Industry*, September (available at www.appea.com.au/content/pdfs_docs_xls/NewsMedia/APPEAMediaReleases/appea_ets_report_23_sep_08_2.pdf).

[7] Both the emissions trading scheme, as proposed in the Green Paper, and the Kyoto Protocol, envisage international trading of this kind, consistent with national commitments.

The extent of cost pass through is the correct measure of trade exposure. It is not simple, as the Government's Green Paper acknowledges, but some products, activities and industries are more trade exposed than others. Australian LNG is at the high trade exposure end of the spectrum because cost considerations in this country have very little influence on realised product prices or, indeed, on prices negotiated for the long-term. The key determinant of price in the LNG market is the next best price offer and the price of cheaper alternatives that are not subject to a carbon price (for example coal in countries with no carbon price)[8].

There is another critical element of the trade exposure test, and this relates to competitor countries' policies. A specific evaluation should be made, initially and at regular intervals, to confirm that the treatment of carbon emissions by competitor countries is not comparable to Australia's regime.

4. ECONOMIC AND ENVIRONMENTAL BENEFITS

The cleaner global contributor initiative would deliver substantial economic and environmental benefits. Australia's prosperity, and its capacity to invest in environmental protection in the future, will be influenced in no small measure by the expansion and profitability of the LNG industry, threatened by the proposals in the Government's Green Paper.

The cleaner global contributor concept is a rational and defensible response to this criticism. It can deliver these economic benefits while at the same time directly advancing the real environmental imperative of reducing global greenhouse gas emissions.

5. EXPLAINING THE MEASURE DOMESTICALLY AND INTERNATIONALLY

The cleaner global contributor concept is a straightforward message. It describes industries or activities that are part of the solution in combating climate change. Indeed it is more difficult to explain why a cleaner global contributor like LNG does not warrant such treatment than to argue the case that it does.

Internationally, the cleaner global contributor concept stacks up. Unlike the earlier Canadian proposal, it does not demand more of the international community. On the contrary, it signals a willingness for cooperation, by providing clear benefits for negotiations that can result in effective sectoral or global agreements between governments.

Accordingly, APPEA commends the concept, observing that without such a mechanism, all the evidence shows that the proposed CPRS will deny the Asia-Pacific region a substantial source of cleaner energy, limit the economic contribution to Australia of its vast gas resources and, paradoxically result in an increase in global emissions.

[8] None of Australia's LNG competitors shows any sign of imposing comparable penalties on emissions any time soon, and there has been no indication that overseas customers are prepared to pay a premium for LNG solely because its origin is a country with an emissions trading scheme.