



25 March 2009

The Secretary
Senate Standing Committee on Economics
PO Box 6100
Parliament House
CANBERRA ACT 2600

By email: economics.sen@aph.gov.au

Dear Secretary

Submission to the inquiry into the exposure drafts of the legislation to implement the Carbon Pollution Reduction Scheme

BlueScope Steel Limited and OneSteel Limited welcome the opportunity to make a submission to the Senate Economics Committee on the draft exposure bills for the Carbon Pollution Reduction Scheme (CPRS). Under the banner of BOSMA (The Bureau of Steel Manufacturers of Australia Ltd) both companies have been constructively engaging with government throughout the design of the Carbon Pollution Reduction Scheme.

While we welcome the Committee's deliberations on the draft Bills, we are disappointed that the time allowed for this inquiry and the Committee's consultations with the Australian community is extremely short, particularly given the economic significance of the policy reforms under consideration.

Given the short timeframe for submissions, and the complexity of the draft legislation, we are not able at this stage to make a comprehensive assessment of the exposure drafts. We would like, however, to take this opportunity to submit our view on the CPRS as proposed and its expected economic impact on the Australian steel industry.

Yours sincerely

A handwritten signature in black ink, appearing to read "David Jenkins".

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A handwritten signature in blue ink, appearing to read "Steve Ashe".

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Executive Summary

OneSteel and BlueScope Steel are the leading firms in the Australian iron and steel industry. Together, the two companies employ 20,000 people in Australia and exported over \$1.6 billion in steel products in the last financial year.

The global economic crisis and the possibility of domestic recession aside, the Government's approach to climate change is the single most important public policy issue currently facing the Australian iron and steel industry.

We support the Australian Government's stated public policy objectives for the Carbon Pollution Reduction Scheme (CPRS); that is, to reduce greenhouse gas emissions while maintaining the competitiveness of Australian emissions-intensive trade-exposed (EITE) industries.

However, there is a clear danger that the CPRS as currently designed will fail to meet the Government's environmental and economic objectives, and instead severely disadvantage the Australian steel industry for little or no environmental gain.

It is highly unlikely that the world's largest steel manufacturing countries, such as China, will impose comparable carbon costs in the short to medium term. Even in the European Union, under the current second phase of the EU emissions trading scheme, iron and steel manufacturers receive 100% free permits for their direct emissions until at least 2012.

The assistance measures for EITEs outlined in the White Paper will not adequately mitigate the impact of the CPRS on the iron and steel industry. Under the CPRS as currently designed, the Australian steel industry will face new and material costs from July 2010, ahead of its major international competitors:

- Although the precise steelmaking activities that will be eligible for assistance are currently the subject of discussion with government, in all probability the effective rate of assistance (i.e. the proportion of the industry's total emissions covered by free permits) will be significantly less than the headline rates of 90% and 60%;
- This assistance will decline each year thereafter at a faster rate than our technical ability to reduce emissions;
- Assistance provided for costs passed on by suppliers of raw materials, services and consumables (Scope 3 emissions) is inadequate and excludes emissions associated with the extraction of metallurgical coal, the steel industry's most significant source of Scope 3 emissions; and
- The Renewable Energy Target (RET) scheme will further increase costs.

The CPRS would impose unsustainable costs on the domestic steel industry. Even after taking account of the proposed EITE assistance, these costs could be in the hundreds of millions of dollars in the early years alone, when Scope 3 costs are included. These major new costs will not be borne by our far larger international competitors for many years, perhaps decades. The CPRS will thus promote carbon leakage, contrary to the scheme's objectives. It will stifle further investment in the Australian industry, including on abatement. It will put Australian jobs at risk.

We believe that the assistance measures for EITE industries in the CPRS should be amended to reduce this unbearable cost burden on the domestic steel industry and meet the original intentions of the Australian Government's policy.

If Australia is to take a leadership position on climate change policy, in order to encourage other countries to act, it must not be at the expense of Australia's EITE industries. One of the fundamental flaws in the CPRS is that it does not adequately shield such industries from the competitive disadvantage that will be caused by Australia acting ahead of international competitors.

Accordingly, we could support the introduction of an emissions trading scheme (ETS) only if it is redesigned to:

- Be affordable and sustainable;
- Impose costs on Australian EITEs in tandem with, and not ahead of, our larger competitors;
- Recognise the technological constraints on emissions abatement in steel making;
- Provide incentives for investment in abatement;
- Take account of the current global and economic crisis;
- Minimise the risks to competitive, trade-exposed Australian manufacturing industry, investment and jobs; and
- Has appropriate transitional mechanisms

Given the global economic downturn, we believe that any emissions trading scheme should not be introduced before 2012 at the earliest. This will allow Australian industry adequate time to prepare for the scheme, government time to develop the myriad of administrative arrangements, and the economy to begin to recover so that companies can afford abatement expenditure. The cumulative emissions reduction associated with the current economic downturn helps provide the Government with this additional time.

1. Overview

BlueScope Steel Limited and OneSteel Limited welcome the opportunity to make this submission to the Committee.

OneSteel (Sydney-based) and BlueScope Steel (Melbourne-based) are the leading firms in the Australian iron and steel industry, servicing customers in the manufacturing, infrastructure, agriculture and building & construction sectors. Together, we employ over 20,000 people in Australia across several hundred sites, and contribute over \$1.6 billion per annum in exports.

The two companies' manufacturing facilities are predominantly in regional Australia, including the Illawarra, Newcastle, Mornington Peninsula and Whyalla, and in the western suburbs of Sydney and Melbourne.

The manufacture of iron and steel creates greenhouse gas emissions, both directly from the chemical processes of converting iron ore and coal to iron and steel, and indirectly from the consumption of electricity. Steel manufacture accounts for approximately 3% of Australia's annual greenhouse gas emissions.

The global economic crisis and the possibility of domestic recession aside, the introduction of a domestic emissions trading scheme is the single most important public policy issue currently facing the Australian iron and steel industry.

We support the Australian Government's stated public policy objectives for the Carbon Pollution Reduction Scheme, that is, to reduce carbon pollution while maintaining the competitiveness of Australian trade-exposed emissions-intensive industry and sustaining jobs in Australia.

However, the policy framework as proposed in the Carbon Pollution Reduction Scheme White Paper will impose substantial new costs on the Australian iron and steel industry that are not faced by our major international competitors. This will constrain our ability to invest and, over time, cause carbon leakage and a net increase in global emissions.

We note the draft Bills contain minimal detail about the measures the government will adopt to offset the loss of competitiveness faced by EITE industries. We understand that some of this detail – such as the definitions of which activities will qualify for EITE assistance – will be included in regulations, to be

released by mid-2009. The EITE assistance measures are of vital importance to the iron and steel industry. In the absence of such detail, it is difficult to fully assess the likely impact of the CPRS.

In this context, we are also concerned that Treasury modelling of the CPRS, released last year, does not provide adequate insight into the likely economic impact of the scheme. It contains puzzling results, flawed assumptions (such as that the entire iron and steel industry will qualify for assistance at an effective 90% level), a high degree of aggregation across industry, and very optimistic assumptions - including assumptions about developing countries committing to an international carbon agreement and assumptions about the costs of abatement. In particular, we note that modelling has not been released of one of the most likely outcomes from the Copenhagen 2009 negotiations – that is, the government's unilateral adoption of a 5% emissions reduction target in the absence (likely, in our view) of either a comprehensive global agreement or substantial commitments from major economies.

Australian steelmakers are prepared to reduce their emissions but can only fund major abatement expenditure if they remain economically competitive.

Australian blast furnaces are efficient by world standards. Blast furnaces are a mature technology, and the laws of chemistry impose significant technical limits on how far the steel industry can reduce its emissions. The Australian steel industry is sponsoring research & development in Australia and overseas, to develop new low-carbon iron and steelmaking technologies but any technological breakthrough is likely to be decades away.

Given these technical constraints, almost all of the opportunities to cut emissions relate to improvements in energy efficiency (such as reusing waste gases to generate electricity by cogeneration) that would lead to a net reduction in indirect (Scope 2) emissions from electricity generation. These opportunities are very capital intensive and typically deliver relatively small, incremental reductions in emissions.

Australia is a small iron and steel producer in global terms, accounting for just 0.6% of global production. China accounts for about 38% of global raw steel production, with the 'BRIC' countries – Brazil, Russia, India and China – together accounting for over 50% of global production.¹ China and the other BRIC countries are the major source of domestic and international competition for the Australian Steel Industry.

In line with the approach of "common but differentiated responsibilities" under the UNFCCC, it is highly unlikely that developing countries such as China and India will take on comparable carbon constraints to Australia in the short or medium-term. Russia has a zero percentage reduction target under the second (2008-2012) commitment period of the Kyoto Protocol.

Even in the EU, which accounts for about 15% of global steel production, under the current (second) phase of the EU emissions trading scheme, iron and steel manufacturers will receive free permits equivalent to 100% of their direct emissions until at least 2012.

The introduction of a price on carbon in Australia in 2010 - ahead of many international competitors - will have a significant and detrimental impact on the relative competitiveness of the Australian iron and steel industry.

The assistance measures for trade exposed, emissions intensive industries proposed in the CPRS White Paper will not be adequate to address this competitive disadvantage.

There is a real danger that the CPRS will fail to meet the Government's environmental and economic objectives. The scheme will lead to carbon leakage to non-carbon constrained jurisdictions with no

¹ Based on production data from World Steel Association media release, 22 January 2009

reduction in global GHG emissions (in fact, emissions may increase), disadvantaging Australian producers with no environmental benefit².

We would only support the introduction of an emissions trading scheme (ETS) that:

- Is affordable and sustainable;
- Imposes costs on Australian EITs in tandem with, and not ahead of, our larger competitors;
- Recognises the technological constraints on emissions abatement in steel making;
- Provides incentives for investment in abatement;
- Takes account of the current global and economic crisis;
- Minimises the risks to competitive, trade-exposed Australian manufacturing industry, investment and jobs; and
- Has appropriate transitional mechanisms.

2. Current business conditions and outlook

The financial crisis is having a severe impact on the global steel industry, with steel demand, production, and prices falling sharply. Most of the world's steel demand is linked to capital investment and consumption, which in turn is highly dependent on capital availability.

World steel output for December 2008 was 25% lower compared to the same month in 2007.³

Globally, capacity utilisation dropped to 70% in quarter 3 of calendar 2008 and was expected to drop further to 63% in quarter 4. Levels of utilization below 60% have occurred only two times - during the Great Depression and during the recession of the early 1980s.⁴

The steel industry globally has responded rapidly to the economic downturn by cutting production and reducing costs. Major layoffs have been announced around the world, plants closed, capital expenditure postponed and demand for raw materials has significantly weakened. (Coincidentally, cuts in production will deliver significant short to medium-term cuts in greenhouse gas emissions).

In Australia, both companies have adjusted production levels downward to meet current and forecast market demand. For BlueScope Steel, this has included bringing forward to January 2009 the reline of the No.5 Blast Furnace at Port Kembla Steelworks, which will be relined and out of service at least until June 2009. The extended closure and reline of the No.5 Blast Furnace is expected to cut raw steel production by at least 1.36 million tonnes (total annual raw steel production at Port Kembla is typically in the range of 5.0 - 5.3 million tonnes).

OneSteel has announced the reduction of operating levels at all major facilities, including reducing blast furnace operations at Whyalla to the bottom of the normal operating range, and a reduction in electric arc furnace production at Laverton and Sydney that has seen steel-make cut by 450,000 tonnes in this financial year. In total, steel-make in this financial year is expected to be down 25% compared to the previous financial year.

BlueScope Steel has also taken measures to raise equity and strengthen its balance sheet by undertaking a \$300 million institutional placement and through a share purchase plan.

² In a speech to the Australian Industry Group on 6 February 2008, Minister for Climate Change and Water, Senator the Hon Penny Wong said: "... the design (of the CPRS) will address the competitive challenges facing emissions-intensive, trade-exposed industries in Australia... There is no point in imposing a carbon price domestically which results in emissions and production transferring internationally for no environmental gain."

³ World Steel Association media release, 22 January 2009

⁴ OECD report, *The Financial Crisis and Outlook for Steel*, 15-16 December 2008.

Since late-2008, both companies have been implementing a range of operational, financial and human resources initiatives that have helped reduce costs and conserve cash, while avoiding job losses amongst our permanent workforces. It should be noted however that significant job losses have occurred with respect to contract and temporary employees

These initiatives have included:

- Extended plant idles and the postponement of non-essential work, with associated bringing forward or rescheduling of leave, as well as some temporary lay-offs.
- Outsourcing and contract labour reduced and work transferred to employees.
- Reduced working hours and overtime.
- Redeployment of personnel as business circumstances change.
- Vacancies from retirements and resignations not filled (i.e. job redundancies through natural attrition).
- Non-essential training and recruitment postponed.
- More options introduced for taking leave without pay (annual and long service).

Employees from both companies have made great strides in implementing cost reduction measures. Unfortunately, continued softness in demand has meant both companies have had to start reducing their global workforces beyond natural attrition.

Reducing employee numbers is a last resort, and both companies are being cautious in maintaining key personnel in anticipation of an eventual upturn in demand. However, any further deepening, or a prolonging of the existing downturn, will inevitably mean both companies will need to take steps to reduce labour costs.

Continuation of current market conditions into 2010 would see the CPRS compound current cost pressures.

3. Why the EITE assistance proposed in the White Paper is inadequate

The CPRS as currently designed would impose a highly significant cost burden on the domestic steel industry that will not be borne by our larger global competitors. These costs would be very difficult to bear in good economic times. In the context of the deep economic downturn – globally and in Australia - the cumulative costs of the CPRS are intolerable and will cause a fall in profitability, investment and jobs.

The White Paper made some improvements to the design of the CPRS, including lifting the expected proportion of free permits to industry (from 20% to 25%). It also provided clarification regarding the administration of the scheme, including an explicit statement that free permits would be available to cover growth in EITE production levels, and that no changes would be made to allocations for existing EITE activities as a result of new entrants.

However, the White Paper proposals do not adequately mitigate the cumulative cost impact of the CPRS on the iron and steel industry.

Key flaws in the design of the White Paper CPRS for the iron and steel industry are:

- Commencement of the headline rate of assistance at a maximum of only 90% from day one.
- An effective rate of assistance that is considerably lower than the headline rate. It is uncertain whether Electric Arc Furnace steelmaking will receive assistance at the 90% or 60% rate, and significant parts of both companies' businesses are likely to be excluded from any assistance.
- Reduction in assistance each year thereafter by 1.3% per annum, which will rapidly exceed the industry's technical capability to abate emissions.

- Assistance provided for costs passed on by suppliers of raw material, services and consumables (Scope 3 emissions) is immaterial and excludes emissions associated with the extraction of metallurgical coal, the steel industry's most significant source of Scope 3 emissions. For the steel industry, Scope 3 emissions could be as much as 5.1 million tonnes of CO₂-equivalent per annum.
- The imposition of the Renewable Energy Target scheme, which will add further costs.

The *effective* rate of assistance (i.e. the proportion of total industry emissions covered by free permits) for both companies could therefore be somewhere between 65% and 75% of total emissions assuming a headline assistance rate of 90% for the integrated steelmaking process and 60% for the EAF process. This is much lower than the headline rate of 90% would suggest and will place a very large financial burden on both companies from the commencement of the scheme.

Inadequate assistance for Scope 3 costs (passing on of emissions costs from suppliers of a range of raw materials, services and consumables) will impose very substantial costs on the steel industry that cannot be passed on. For the steel industry, Scope 3 emissions could be as much as 5.1 million tonnes of CO₂-equivalent per annum.

Our current understanding is that Scope 3 compensation will be restricted to emissions associated with the use of natural gas as a chemical feedstock, and the production of cryogenic gases.

The largest source of Scope 3 costs is likely to be metallurgical coal, most of which is sourced from the Illawarra collieries, which are gassy mines. BlueScope Steel is a captive customer of the collieries, with dedicated rail infrastructure established to bring coal from the collieries to the nearby Port Kembla Steelworks. There is currently no infrastructure for shipping and storing alternative supplies of coal. OneSteel also purchases the bulk of its metallurgical coal from these mines.

Unfortunately, although the White Paper recognised Scope 3 costs may be an issue for some industries, it did not satisfactorily tackle this important source of new costs to the steel industry.

The impact of the Renewable Energy Target (RET) scheme will further significantly increase costs.

Our analysis indicates that the CPRS will impose unsustainable costs on the steel industry and severely damage its competitiveness, with investment and jobs put at risk.

Our key competitors will not face these carbon costs for a long time, which will compound the negative impact on the Australian steel industry.

We believe that the CPRS should be amended to reduce its unbearable cost burden on the domestic steel industry.

We believe the scheme must be re-designed to protect international competitiveness and provide genuine incentives to reduce emissions.

In conclusion, we believe that an affordable and sustainable ETS would:

- Move in tandem with, and not ahead of, our competitors;
- Recognise the technological constraints on abatement in steel making;
- Provide incentives for investment in abatement;
- Reflect the current economic crisis;
- Minimise the risks to jobs, manufacturing industry and the economy; and
- Has appropriate transitional mechanisms.

We believe that the significance of the CPRS warrants the close attention of the Committee and that more time might have been allowed for the inquiry to deliberate on the draft legislation. We thank the Committee for its consideration of our submission on this major environmental and economic reform.