



**Submission to the Senate Standing Committee on
Economics**

**Carbon Pollution Reduction Scheme and
exposure draft legislation to implement the
scheme**

March 2009

EXECUTIVE SUMMARY

The exposure draft legislation on the Carbon Pollution Reduction Scheme (CPRS) proposes to bring the environmental cost of greenhouse gas emissions into the prices of goods and services in the Australian economy. This will be a significant economic issue for the foreseeable future. We welcome this opportunity to provide a submission to the Senate Standing Committee on Economics on the CPRS and its exposure draft legislation on behalf of our members.

It is certain that the CPRS will raise costs for energy users. The EUAA has over 100 members and this includes most of the nation's largest users and companies that will have to acquit permits under the CPRS, as well as being significantly impacted by the higher electricity prices it will bring about. Our members will also either have to seek to pass on the costs of the CPRS, to the extent they can, or absorb its additional costs. Our members' profits will decline if they are not able to pass these cost increases on to their customers. The scheme could have a significant impact on their commercial operations in Australia and potentially on the continued viability of some. This will detrimentally affect their competitiveness and hence their ability to employ people and create wealth.

While the scheme will result in some energy users gaining a competitive advantage, on average, the impact will be negative at least for the next decade or so. Therefore this is a policy development that energy consumers cannot accept without question. Nevertheless, we recognise that it may be in Australia's long-term interest to embrace this change now.

Whilst the EUAA appreciates the opportunities that have been provided so far for consultation on the CPRS, it has experienced difficulties in determining a position on aspects of the exposure draft legislation due to the extremely short time-frames given to stakeholders to respond to the inquiry. Considering the complexity of the issues at stake and the impact that the CPRS will have on Australia this short time frame is a matter of concern.

CPRS Principles and Framework

In preparing our response, we have reviewed the policy principles set out in the White Paper and the exposure draft legislation. While we have no particular disagreement with these, there are particular matters that we think should more explicitly guide the design of the CPRS.

The Impact on energy users should be a key policy variable: Energy users are facing much higher energy costs for a variety of reasons, besides the impact of emission prices. These include large price increases when they re-contract for energy, a massive expansion of renewable generation, the impact of the drought, rapid escalation in capital and operating costs for energy infrastructure and rising gas costs, including the development of LNG exports. Our own members have already seen 50 per cent increases in electricity costs when they re-contract and this is causing them to pay much higher energy bills, with further increases in prospect. Contracting beyond 2010 is very difficult due to the expected introduction of the CPRS. Many are now facing tougher economic times due to the economic downturn. Whilst we appreciate that the CPRS is a long term measure, these matters need to be taken into account in deciding the design, initial trajectory and implementation date of the CPRS, since its introduction in a time of rising energy costs and economic downturn could magnify its cost imposts and impact on the economy.

The scheme should be able to adjust to new information efficiently: The main costs and benefits of climate change mitigation lie hundreds of years into the future. Economic assessments of costs and benefits – many of which are not valued in a market – over this time span, are problematic not just because of their uncertainty but also because there are a variety of plausible ways to discount these back to the present. There are few major economic issues that are as poorly understood, long term and difficult to predict as the economics of climate change. In this context, while acknowledging the value of certainty to investors and consumers, we suggest that the Government should ensure that the CPRS is able to efficiently respond to new information as it becomes available. Specific areas where we think that this should be reflected in scheme design include the definition of emission reduction trajectories, particularly their relationship to international agreements, and new information on climate science and economics; the relationship between the CPRS and complementary measures, including renewable energy policies; and the arrangements for the compensation of emission-intensive trade-exposed industries.

Income from the sale of permits should be used to facilitate emission reductions: The White Paper states that around 75 per cent of Australia's emissions will be covered under the scheme and that 75 per cent of the permits will be auctioned by the Government. The Federal Government estimates that in the first two years of the scheme the auctioning of permits could bring as much as \$11-12 billion dollars of revenue to the government. The way that the Government distributes the income that it receives from the auctioning of permits will have a significant impact on the rate and efficiency of the transition to a low carbon economy. We strongly urge that permit income be used to reduce energy demand through demand-side efficiency measures, to reduce the emission intensity of energy consumption and to increase the supply of low emission electricity production.

Specific Comments

Comments on specific design issues are set out below.

Coverage. The EUAA supports coverage by the scheme that is as broad as possible. This is critical to ensuring that the scheme meets the requirement that it is economically efficient and also more equitable. We therefore strongly support the proposals to cover all six Kyoto greenhouse gases and to commence the scheme with as broad coverage as possible. We also support the proposal to include agriculture in the scheme from 2015, provided measurement issues have been satisfactorily addressed. We also suggest that a review of how this can be achieved begin immediately after the scheme commences.

Price caps and borrowing: The EUAA has no objection in principle to price caps for the initial period. However, as discussed above, a price cap that is so high that prices will seldom reach the level of the cap is likely to mean that Australian permits will achieve price parity with internationally traded permits, less the cost of carry. Once the Australian scheme becomes internationally linked, liable parties will have the ability to sell permits that they have banked. In this way, the effect of the scheme proposed by the Government may result in prices that are consistent with international linkage from the beginning of the scheme. This is clearly not what the Government intends. For this reason, we suggest further consideration of the relationship between initial price caps, international linkage and banking.

International linkage: The Government has said that the scheme has been designed so that it can link with international markets. The Government has also said that it prefers to have international linkage after 2013. Under the CPRS, Certified Emissions Reduction units (CERs),

Emissions Reduction Units (ERUs) and Removal Units (RUs) will be able to be surrendered for compliance under the scheme. The Government has also suggested that it will give a minimum of five years notice of a decision to allow the sale and transfer of Australian permits to international markets; except for the situation where a bilateral link is established. Australia will be a price taker if it links to internationally traded permit markets. To properly understand the impact of the proposed emission trajectories, it is advisable for a proper analysis to be undertaken of international emissions certificate prices and their potential impact on the prices of Australian permits.

Compensation: The EUAA supports compensation for emission intensive trade exposed (EITE) industry as a time-limited transition measure; however, the proposed scheme merits further consideration. We are especially concerned that the scheme will leave some industries that are trade exposed vulnerable to the CPRS, such that their operations will suffer, jobs will be lost and carbon leakage will occur.

The EUAA does not support the Electricity Supply Adjustment Scheme, whereby certain coal-fired generators will receive \$3.9 billion in compensation. There will be many participants in the Australian economy that will not be able to fully pass on the cost of emissions, but electricity generators are likely to be better able to do so than most. This was certainly the experience in the EU. Electricity generators that may not be able to fully pass on their costs are not a special case and in our view are no more eligible for compensation than other Australian businesses that are not trade-exposed. As mentioned above, some industries that are trade exposed and emission intensive, but not sufficiently to qualify under the EITE proposals, may be placed in a far worse position than coal-fired generators.

As noted earlier, the emission intensity of electricity production in Australia is the highest of any other major economy. This is predominantly due to the very high penetration of coal-fired generation capacity. The biggest emitters are old, highly inefficient brown coal and black coal thermal capacity in Victoria and New South Wales.

The imposition of an emission price is likely to have a very significant impact on variable costs for coal-fired generating plant. Energy users will have no choice but to bear this additional cost until more efficient, and lower cost combined cycle gas generation is able to displace this capacity. However, these power stations are unlikely to close until they are displaced by lower emission plant in the merit order dispatch that governs the electricity market. The CPRS should ensure that they are closed down at that point. The ESAS scheme will prolong this process.

As the Government is going to provide compensation to coal-fired electricity generators, we strongly suggest that this compensation should be linked to actions that will hasten their exit from Australia's power system to be replaced by more efficient combined cycle gas or renewable capacity. This could be achieved by making compensation available in the form of capital grants for investment in low emission generation to replace existing coal plant, or to facilitate biomass co-firing. This is consistent with the Government's proposal for the Climate Change Action Fund.

A compensation scheme that is designed to achieve this will produce benefits for energy users in the form of lower prices, and to the Australian community in the form of lower emission prices and more rapid greenhouse gas emission reductions, while still addressing the Government's concern to preserve Australia's reputation amongst international investors.

Complementary measures: The EUAA agrees that the CPRS should be the cornerstone of Australia's emission reduction policy. However, there may be a place for complementary measures, and not just to deal with market failures. The EUAA strongly recommends that such complementary measures should be funded through income from permits. Specifically, the additional burden of the expanded Renewable Energy Target (RET) – whose main purpose is emission reduction – should be funded through emission permit income, rather than users funding such programs through the purchases of Renewable Energy Certificates. However, any financial programs to help reduce emissions must be robustly designed, well administered and subject to scrutiny and independent review.

CPRS Draft Bills

Our submission also comments on elements of the draft Bills that give effect to the CPRS. The main elements of the legislation addressed are:

- Objects of the CPRS set out in the main bill, where we comment on the objects proposed and on the absence of a specific object relating to the economic implications of the scheme;
- Matters the Minister must and may have regard to in making decisions on the CPRS, where we suggest that points relating to economic implications and global action on climate change should be elevated to “must consider” and query the meaning of some of the proposed wording in this part of the Bill;
- Query the proposal to leave detail about setting of caps and gateways to regulations;
- Suggest that it would be preferable to remove the differences in the approach to liability under the CPRS and the NGERs, if at all possible;
- Draw attention to the significance of the proposed penalty rate (\$40 per tonne CO₂-e) under the CPRS and its rate of annual increase (5 per cent) and suggest that these could be (inappropriately) based on underestimates of the costs of the CPRS in Treasury modelling, and that a more modest penalty regime could be in order for the first 3-5 years of the scheme;
- Suggest that the Committee examine carefully the proposal that there will be no exports of Australian Emission Units (AEUs) initially and the basis for this;
- Support the Government's stated “co-operative compliance” approach to enforcement, and make a number of suggestions to tailor enforcement penalties in the early years of the scheme to suit this approach and recognize the need for liable parties to get accustomed to a major new policy such as the CPRS;
- We note the lack of detail in the draft Bill about the EITE proposals and the uncertainty and costs that this is already creating for EUAA members seeking EITE status;
- We raise questions about the veracity of the ‘windfall gain’ and ‘power system reliability’ tests to be applied to coal-fired generators, which could be open to gaming;
- Express support for the proposed five-yearly expert reviews of the CPRS and highlight the need for these reviews to be transparent, independent and public;
- Propose that AEU not be classified as financial products in view of their role in the physical trade of carbon, as well as the additional regulatory burden and costs associated with classing them as financial products; and

- Support the proposal for an independent regulator covering the CPRS, RET and NGRS, with merits based appointments, statutory independence and transparent processes.

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1 INTRODUCTION

The Federal Government's Carbon Pollution Reduction Scheme (CPRS) proposes to bring the environmental cost of greenhouse gas emissions into the prices of goods and services in the Australian economy via a national emissions trading scheme (ETS). This will be a significant economic issue for the foreseeable future involving potentially major economic adjustments.

The CPRS will raise costs for energy users. Our members' profits will decline to the extent they are not able to pass these cost increases on to their customers. This will detrimentally affect the competitiveness of some of our members, and hence their ability to employ people and create wealth for the Australian economy.

While the scheme will result in some energy users gaining a competitive advantage over others, overall the impact will be negative at least for the next few decades. Therefore this is a policy development that energy users cannot accept without close and careful analysis as to its impacts on them. Nevertheless, we recognise that it may be in Australia's long-term interest to embrace this change.

The scale of the undertaking to de-carbonize Australia's economy cannot be under-estimated: Australia has the most greenhouse gas emission intensive electricity production of all OECD member countries, and the rate of growth of emissions from Australian electricity generation has been faster than almost all our trading partners. It will be a difficult and long process to reverse this. Carbon has provided a fundamental underpinning to our economic prosperity, something that the vast majority of Australians would wish to continue. It is therefore vital to ensure that this transition is managed well.

This submission responds to the call for submissions by the Senate Economics Committee to its review of the CPRS exposure draft legislation. We appreciate the importance of the bills, this review and the opportunity to provide a submission. Our submission draws on previous submissions we have made to the Government and Garnaut Review, as well as our preliminary assessment of the draft bills.

1.1 The EUAA's Interest in the CPRS

The EUAA is a non-profit organisation funded by membership fees, internally generated revenue and external funds. It is focused entirely on energy issues and was formed in 1996. Members determine EUAA policy and direction and elect a Board made up of fellow members. The Association members are business users of energy with activities across all states and many sectors of the economy. The EUAA has over 100 members and this includes most of the nation's largest users and companies that will have to acquire permits under the CPRS, as well as those being significantly impacted by higher electricity prices. Our members will either have to seek to pass on the costs of the CPRS, to the extent they can, or to absorb its additional costs. The scheme could have a significant impact on their commercial operations in Australia and on the continued viability of some.

Our members use significant amounts of energy and, coming from many different parts of the economy and different States, the CPRS will impact them somewhat differently. Members also have somewhat differing views on the CPRS and some will make their own individual

submissions on the White Paper. The views expressed in this submission are therefore broadly representative of interests of the EUAA membership and energy users more generally.

1.2 Context of Our Comments on the Provisions of the Draft Bills

In this submission, the EUAA provides some comments on the six exposure draft Bills under consideration by the Senate Economics Committee. The main focus is on the *Carbon Pollution Reduction Scheme Bill* as this outlines the main provisions of the scheme and the ones which will have most impact on energy users. Our comments are based on the draft legislation and also a helpful briefing provided to the Emissions Trading Scheme Industry Roundtable, of which the EUAA is a member, by the Department of Climate Change on 20 March 2009. Nevertheless, our ability to assess and comment on the draft CPRS legislation in this submission has been limited by the complexity of the scheme (reflected in the draft legislation), by the lack of some important details in the Bills (we understand that this will emerge in the regulations and other subordinate instruments), by the limited time for which the draft bills have been available and by the short time for this review (one month to completion, with submissions due after 2 weeks). Our comments have therefore been constrained by these factors. We have not commented on all aspects of the Bills and restricted our remarks to areas where we have identified issues for consideration that are of interest to energy users.

1.3 Modelling the Impacts of the Scheme on Energy Users

The EUAA has recently commissioned its own modeling of the likely impacts of the CPRS and the 20 per cent Renewable Energy Target (RET) on energy users. This will show impacts such as those on electricity prices and the electricity market, as well as more general economic effects. It will therefore provide a uniquely 'energy user perspective' on the CPRS and 20 per cent RET. It is expected that this study will shed light on how energy users could fare under joint implementation of a CPRS and a 20 per cent RET.

Unfortunately, this work is not complete and is therefore not available for inclusion in this submission, but we expect that it will assist us and energy users to be better able to determine the impacts that these two measures will have on them; and therefore to help the EUAA and energy users to determine their ultimate position on both measures. Once this work becomes available we intend to bring it to the attention of the Government and thereafter make it publicly available.

2 OVERARCHING COMMENTS ON THE PROPOSED CPRS AND EXPOSURE DRAFT LEGISLATION

This section provides comments based on the EUAA's assessment of the CPRS as outlined in the White Paper and draft Bills. The comments are made from the overall perspective of EUAA members as significant users of energy and who will be significantly impacted by the CPRS.

2.1 CPRS Policy principles and framework

We have reviewed the policy principles set out in the White Paper. While we have no disagreement in principle with these, there are particular issues that we think should be directly considered in the design of the CPRS.

2.1.1 The impact on energy users should be a key policy variable

The decision to implement emission prices coincides with several other changes that are driving up energy prices:

- EUAA members, who have entered the contract market since early 2007, report an average increase in electricity contract prices of some 50 per cent compared to their previous contracts.
- There has been a massive expansion of investment and increase in operating costs in the electricity transmission and distribution sector. In parts of Australia, prices have more than doubled in real terms over the last decade.
- The massive expansion in the renewable electricity target will require total capital investment of around \$50bn to \$60bn between 2008 and 2020. The full additional cost of meeting this target is borne by energy users as these costs will be passed through to them in higher power prices.
- The drought has had a severe impact on the electricity market particularly in the Snowy, Victorian hydro and Tasmania. Drought conditions continue in Victoria and could affect thermal generation plant unless there is an improvement. Meanwhile, the impact of the drought and related factors continues to keep contract prices higher than they otherwise would be.¹
- The price of coal has tripled over the last few years. This can be expected to have a significant impact on those electricity generators who have already or need to renew contracts and who are exposed to internationally traded coal prices.
- There has been a long period of low levels of investment in base load generating capacity. The margin between installed capacity and demand that existed before the creation of the NEM has been progressively reduced. Furthermore, the capital cost of new equipment has risen considerably due to labour and commodity price increases. Much higher capital costs at a time of significant investment need, will lead to higher average electricity prices.

¹ A recent study commissioned by the EUAA concluded that the drought was the underlying cause of higher electricity prices in 2007, but that a range of related factors also contributed, including transmissions constraints, "opportunistic bidding" by non-drought affected thermal generators, higher levels of plant outages than normal and greater use of gas fired generation. See Creative Energy Solutions, *Independent Investigation into the Causes and Consequences of High Prices in the NEM*, July 2008 at http://www.euaa.com.au/whats_new/index.htm.

- Queensland's nascent coal seam gas (CSG) industry has quickly become dominated by international LNG developers. Successful development of these projects can be expected to drive up gas prices in Queensland and ultimately the rest of Australia, to their internationally traded prices, net of the cost of production and transport. This price could be several times higher than current gas prices. With a greater reliance expected on gas-fired generation under the CPRS, this would also drive up power prices in future and may make the CRPS trajectory more difficult to achieve.
- The likelihood of a future carbon price beyond 2010 is also creating uncertainty for energy users seeking to contract beyond that year. The market is pricing power from 2011 and beyond as if there were a carbon price. This has two effects: (1) there is a premium built into the prices due to uncertainty about the ultimate carbon price; and (2) there is less willingness to contract beyond 2010 and hence liquidity has dried up, making contracting more difficult.
- Economic times have worsened over the past six months, especially for the mining and manufacturing sectors and the prospect of significant additional cost burdens would be poorly timed. This includes industries that are trade exposed but not considered emission intensive enough to justify compensation (those whose emissions are under the 1,000t CO₂-e threshold in the White Paper). In raising this point, we appreciate that an ETS is a long-term policy measure that will need to apply over many economic cycles. Nevertheless, its impact could magnify the dampened economic conditions being seen at the moment and this fact should be carefully considered in relation to the formative years of the scheme. This is something that we will be considering further as part of the modelling.

It is in this context that an emission price is being introduced. The higher costs of energy that result will also dampen demand for energy, encourage energy saving and reduce the growth in emissions below what it otherwise would be. The effect of these variables on energy prices needs to be carefully considered in deciding emission reduction targets and consequent emission prices. This has particular implications for the allocation of emission permit income.

2.1.2 The scheme should be able to adjust to new information efficiently

It is well established in the economics of climate change that the main costs and benefits of mitigation lay well into the future – up to hundreds of years into the future. Economic assessments of costs and benefits over this time span – many of which are not valued in a market – are deeply problematic not just because of their uncertainty but also because there are a variety of plausible ways to discount these back to the present.

In addition, there is a great deal of uncertainty on important data elements not just far into the future, but also in the present and recent past. For example, less than a year after he finalised his report, Lord Stern suggested that he had significantly under-estimated the rate of climate change and greenhouse gas emissions. Similarly, in his report, Professor Garnaut defined a “platinum age” business-as-usual emission trajectory higher than even the highest scenario in the IPCC's Fourth Assessment Report published in 2007. The estimates of economic costs and benefits are also subject to great uncertainty over time, the more so for such a very long term analysis.

There are few other major economic issues that are (relatively) as poorly understood, long term and difficult to predict as the economics of climate change. In this context, while acknowledging the value of certainty to investors and consumers, we nevertheless suggest that

the Government should consider carefully how it is able to ensure that the CPRS will efficiently respond to new information as it becomes available. Specific areas where we think that this should be reflected in scheme design are as follows:

- The definition of emission reduction trajectories and particularly the relationship to international agreements and new information on climate science and economics;
- The relationship between the CPRS and complementary measures, particularly renewable energy policies;
- The rules for international linkage;
- The future path of international negotiation and agreements on climate change and what specific paths and features might be agreed to;
- How the CPRS would impact with changing economic circumstances, particularly if higher economic growth impacts on the trajectory or if a future recession (or depression) is amplified by the scheme; and
- The arrangements for the compensation of emission-intensive trade-exposed industries, particularly in view of the range of possible emission reduction policies adopted in other countries.

2.1.3 Income from the sale of permits should be used to facilitate emission reductions

Assuming that the CPRS covers 75 per cent of Australia's anthropogenic emissions and that 75 per cent of the permits are sold by the Government (not including agriculture from the commencement of the scheme). The Federal Government estimates that revenue from the auctioning of permits will bring approximately \$11-12bn per annum in the first two years of the scheme. While the volume of permits sold will decline as emissions decline, this is likely to be more than offset by rising permit prices and reduced compensation to emissions intensive trade exposed industry.

Clearly the sale of emission permits will be a significant source of revenue to the Government, and this will grow in importance over time. The way that the Government distributes the income that it receives from the auction of permits will have a significant impact on the rate and efficiency of the transition to a low carbon economy. While compensation for low income families and emission intensive trade exposed industry is reasonable, we strongly urge that the redistribution of the remaining permit income be used to reduce energy demand through demand-side efficiency measures, to reduce the emission intensity of energy consumption and to increase the supply of low emission electricity production. These measures will help to minimize the impact of emission prices on the cost of energy.

These measures will help minimise the impact of emissions prices on the cost of energy. As outlined below, the EUAA cannot see a justifiable case for compensating coal-fired generators for the impacts of the CPRS. This compensation would be far better directed at lowering Australia's emissions more quickly. This can be done through lower emission technology and energy efficiency; and offsetting the impacts of the CPRS that really matter.

2.2 Objects of the CPRS Bill

The main Bill sets out the objects of the CPRS. This includes the CPRS as the "key policy tool" to meet Australia's international greenhouse obligations. We do not dispute that the CPRS should

be a key plank, but also believe that it would be useful to say that there are other policy measures that play a role.

A concern we have is that the CPRS is an emissions trading scheme, a policy approach to reducing greenhouse gas emissions that has sound economic foundations but is relatively untried and its success is yet to be proven. Such schemes are complex, relatively unknown and rely on an uncertain price for carbon which initially at least will need to have most of its impact in the electricity sector. However, electricity is a product that is known to be highly price inelastic such that large price shocks may be needed to achieve given reductions in emissions.

A second object of the scheme is to contribute to an effective global response to climate change. We recognise the need for this object and note the importance of achieving a global solution to the global issue of climate change. Countries acting alone cannot achieve this objective.

The third object is to take action to reduce Australia's emissions to the targets previously specified by the Government, namely, 60 per cent below Australia's 2000 levels by 2050, an unconditional 5 per cent below the 2000 level by 2020 and 15 per cent below this level by 2020 if all major economies also commit to substantial reductions. This is essentially a re-statement of the Government's previously announced policies on this matter and it is therefore appropriate for the Government to include it.

We believe that the Bill should also include an object that recognises the economic impacts of the CPRS, as well as the climate change aspects already listed as objects. In this regard, we note that the Government has always referred to the CPRS as an environmental and economic policy, including its credentials as a major economic reform to rival those of the 1980s and 1990s.

2.3 Ministerial Decisions

The draft CPRS Bill sets out a range of factors that the Minister is to have regard to in making decisions around the CPRS.

The Minister must have regard to:

- Australia's international obligations; and
- The five yearly expert advisory reports on the CPRS.

The Minister may also have regard to:

- The goal of stabilization of global emissions at 450 ppm of CO₂e;
- Global action on climate change;
- The economic implications of decisions;
- Voluntary actions;
- Estimates of unevaluated emissions; and
- Other relevant matters

The EUAA supports the approach of providing guidance on matters that the Minister is to consider in decision-making. This should help to ensure a more predictable and sounder set of decisions around the CPRS and improve its certainty for those most affected, especially parties

with liability such as larger energy users. Critical to this, however, is the 'quality' of the factors listed above and how they are interpreted.

We understand the reasoning behind the two factors that the Minister must have regard to. In relation to the first, it is normal practice for Australia to do this with legislation that has an international context, as the CPRS does. However, it could be clarified that in relation to climate change, the need for international action is critical to the effort that Australia is able to reasonably (and effectively) make. In relation to the second, we support that the Minister should have regard to the five-yearly expert reports on the CPRS. The quality of these reports will, in turn, be critical to their effectiveness. We comment further on this below.

Turning to the factors that the Minister may have regard to, we query the need and desirability of including the stabilization of global emissions at 450 ppm. This is a goal supported by the Garnaut Review and in some international work (including the IPCC). Hence, it does have a status but, so far as we are aware, it does not relate to any previously enunciated Government policy position on climate change or the CPRS. The Government has a current policy of reducing our emissions to 60 per cent of 2000 levels by 2050 and it would be preferable to refer to this rather than a goal that has not been previously set as Government policy. We also query the desirability of including such a factor at all? One concern here is that such objectives may change over time as the science of climate change evolves, or in light of economic or other developments. It would then require a change in legislation to reflect this.

The second and third factors listed, namely, global action and economic implications, are particularly important ones. Global action is critical to an effective climate change response that shares the burden and minimizes economic costs. The Government should always have regard to economic implications in making important policy decisions. We believe that these two factors are so important that they ought to be ones that the Minister must have regard to.

We are unclear as to the meaning of the words "voluntary actions" in the context of factors that the Minister may have regard to. We understand that this could refer to individual and household actions to reduce emissions and that it is intended that the Minister will exercise judgement in considering this. We are concerned about the lack of understanding of how this factor will be interpreted, and would urge that this be clarified and that the scope for exercise of judgement be narrowed as far as possible to provide greater certainty and clarity.

The phrase "other relevant matters" is also one upon which we would comment. We understand that this is a 'catch all' phrase that would allow the Minister to exercise judgement by reference to the word "relevant". This should be clarified. We would not want to see a situation emerge where the Minister can apply too much flexibility in this area. To do so would reduce certainty, predictability and could introduce a range of factors into decision making that are inappropriate. How relevant would something have to be to be considered?

2.4 Implementation date

The Government proposes that the CPRS commence on 1 July 2010. Since this date was set, the world economic outlook for the next few years has changed dramatically with the global financial crisis and many economies are in decline. The prognosis for the Australian economy has turned sharply worse. This has caused some people, including some business groups, to argue that the Government ought to delay implementation of the CPRS.

The EUAA wrote to the Prime Minister in October last year asking for Government consideration of how the economic downturn then emerging might affect the implementation of the CPRS by mid 2010. The EUAA noted that implementing the CPRS during an economic downturn could make the impacts of the CPRS on the economy worse, whilst a downturn would also reduce the growth in carbon emissions. We also suggested that the Government should consider not proceeding with implementation of the expanded RET. However, we also acknowledged that there could be downside risks from any delay in implementation and that this could require lost ground to be made up later. We said that work with the design of the CPRS should proceed to the point of establishment regardless to provide certainty for investment.

Since that time, the economic outlook has deteriorated, Australia's GDP has gone into decline and unemployment has worsened. Among those EUAA members with the greatest exposure to the CPRS, many are now skeptical about introducing an ETS at this time.

We remain concerned about this matter and our modelling will consider it further.

3 COMMENTS ON SPECIFIC ISSUES

In this section, we comment on some of the specific design principles for the CPRS, particularly as they affect energy users.

3.1 Coverage

The EUAA supports coverage by the scheme that is as broad as possible. This is critical to ensuring that the scheme meets the requirement that it is economically efficient and more equitable. We therefore strongly support the proposal to cover all six Kyoto greenhouse cases and to commence the scheme with as broad coverage as possible.

We also support the proposal to include agriculture in the scheme. We note that this will be reviewed in 2013 with an objective of including agriculture from 2015. We would encourage the Government to include agriculture from 2015 or earlier if possible, provided measurement issues have been satisfactorily addressed.

3.2 Initial price caps

The EUAA has no objection in principle to price caps for the initial period. However, a price cap that is so high that prices will seldom reach the level of the cap is likely to mean that Australian permits will achieve price parity with internationally traded permits, less the cost of carry. This is because, once the Australian scheme becomes internationally linked – as the Government intends after 2013 – liable parties will have the ability to sell permits that they have banked. In this way, the effect of the scheme proposed by the Government may result in prices that are consistent with international linkage from the beginning of the scheme. This is clearly not what the Government intends. For this reason, we suggest further consideration of the relationship between initial price caps, the Kyoto permits that will be allowed to be surrendered under the scheme from 2013, and international linkage and banking.

3.3 Status of AEU's

An issue that arises in relation to the status of AEU's is whether they should be considered as financial products. This would make them subject to a range of Australian financial services regulations, including the need for an Australian Financial Services Licence to trade AEU's. This would increase the costs and complexity of liable parties and auctioning.

We can see no valid reason to go down this route. AEU's will not be financial derivatives but rather instruments involving the physical acquittal of right to produce greenhouse gases. This is akin to the trade of electricity in the NEM spot market, which involves the physical production of electricity and its sale to 'market customers'.

There is a separate issue about derivatives in the secondary market for carbon that is expected to develop around the CPRS. This is akin to the trade in electricity derivatives that have developed around the NEM and which are subject to financial services regulation.

Some EUAA members will have direct liability under the CPRS and may well decide to participate in trade of AEU's. Classifying them as financial products would make this task more costly and onerous for them.

3.4 International linkage

The Government has previously expressed a preference for linking Australia's emissions trading scheme with schemes in other countries. However, in the White Paper and draft legislation the Government proposes that the CPRS will not be internationally linked (i.e. Australian permits cannot be exported in the initial years of the scheme).

We understand that this is because of legal and technical issues, conflicts of law between countries and rule differences which make this too difficult. We appreciate that these difficulties could well make this necessary but it would be useful for the Senate to examine this in more detail.

The Government has said that the Kyoto Certified emissions reductions (CERs) units, emissions reduction units (ERUs) and removal units (RUs) will be eligible for surrender from 2012-13 onwards. We assume that this means that the Australian Government is concerned that the international price of emission permits (i.e. the EU Allowances) is higher than the Government considers appropriate in the Australian economy at this time. If this is the case, it would be helpful to describe in more detail why the Government considers this to be so, and whether convergence of Australia's emission prices with EU Allowances would be a condition for international linkage after 2013. This will help to reduce uncertainty around the future of the scheme and its carbon price, which will be critical to longer-term investment decisions by business and in the energy sector.

We appreciate there is a trade-off between the desirability of linking to gain access to international markets and help to ensure the least cost path to reducing carbon versus the risk that we could import a higher carbon price.

3.5 Banking

The proposal to allow emission permits to be banked from the start of the scheme will create an opportunity for arbitrage if there is an expectation that emission prices will rise when the price cap is lifted and eligible Kyoto units are eligible for surrender, or when the Australian scheme links to international schemes or bilateral schemes such as the scheme that New Zealand is establishing. This arbitrage will create windfall profits to polluters, at the expense of energy users who will bear a large proportion of the cost of emissions.

This may not occur if the price cap is set high enough, i.e. above the internationally traded price of emission permits. However, in this case the effect of banking is likely to mean that emission prices rise to the internationally traded price of emission permits. This is likely to defeat the purpose – as described in the White Paper – of not linking Australia's scheme to the international market.

The EUAA therefore suggests that further consideration be given to the issue of the inter-relationship between the arrangements for banking, the price cap and the justification for not proceeding with international linkage from the start of the scheme.

3.6 Borrowing

We support the allowances for the limited short-term borrowing of permits and the ability of participants to discharge up to 5 per cent of their obligations by surrendering carbon permits dated from the following year.

3.7 Compensation

The Government has suggested that 75 per cent of Australia's emissions would be covered by the scheme and the auctioning of 75 per cent of those emissions, with 25-35 per cent being held back for EITE industries and a further proportion for the certain coal-fired generators.

Revenues generated by the auctioning of these permits will be routed back to households and businesses through the Climate Change Action Fund or via the taxation and benefits system to help adjustment and to promote investment in clean energy.

Our comments on the proposed compensation to EITE, coal-fired electricity generators and households are set out below.

3.7.1 Emission Intensive Trade Exposed (EITE) Industries

The EITE provisions of the scheme are intended to avoid 'carbon leakage' and promote orderly adjustment for industries that are exposed to international competition (from exports or imports) from countries that do not have emission reduction schemes in place. There has been some commentary that this proposal 'rewards the polluters'. However, the EITE approach is sound if Australia is to avoid exporting carbon elsewhere and do so at the expense of local industries and jobs. This is why the principal was supported by the Garnaut Review, albeit in a different form to that in the CPRS.

Nevertheless, the EITE approach is complex and only necessary because the Government is introducing the CPRS in advance of concerted global action. It will also inevitably involve an element of arbitrariness and problems will emerge. One of our greatest concerns with the EITE approach in the CPRS is that it may create a situation where exposed Australian industries are badly damaged because not enough is known about their circumstances. We believe this could become a significant issue over time.

The draft CPRS contains little detail on the EITE proposal. We understand that this will be contained in regulations and guidelines. Whilst we recognise that the proposals are complex and involve a significant amount of work to specify correctly, we are concerned that there is insufficient scrutiny being permitted by reliance on regulations to set out details of the scheme. This is partly driven by the Government's timetable for introduction of the CPRS by 1 July 2010.

A number of EUAA members are currently involved in detailed assessment of their EITE status. They report receiving helpful support from the Department of Climate Change, but also that their ability to undertake assessments is affected by the lack of detail about this important element of the CPRS and that they have concerns that the substantial work they are doing could be negated by EITE details yet to emerge. They also report that this makes deadlines for the provision of information difficult to achieve.

3.7.2 Assistance for Significantly Affected Industries

The CPRS will provide assistance by way of free permits to industries said to be ‘significantly affected’ by the CPRS. This effectively means coal fired generators with the highest carbon emissions. As stated above, we have serious issues with this aspect of the CPRS and do not believe that such assistance is justified.

The proposal outlined in the draft Bill involves:

- The issue of free permits to certain coal-fired generators for the first five years of the CPRS;
- The allocation of 130.7 million free permits;
- The application to coal fired generators on a *pro rata* basis using an annual assistance factor;
- The application of a ‘Windfall Gain’ test to ensure that assistance only goes to generators who are not in a position to obtain a windfall from free permits;
- The application of a ‘Power System Reliability’ Test to ensure that generators receiving free permits maintain their name-plate capacity.

The White Paper outlined that the free permits issued were estimated to be worth \$3.9 billion over five years.

The EUAA also has concerns about that ‘windfall gain’ and ‘power system reliability’ tests to be applied. In relation to the former, we note the lack of specificity in the Bill as to how this test will be applied. Generators will need to make submissions to the regulator about this. The assistance proposed is significant and could well prolong the lives of these generators, without there being a risk to the power system, and the requirements ought to be subject to careful assessments to avoid the risk of gaming.

Regarding the ‘power system reliability’ test, the reliance on name plate standards could be open to manipulation and could allow generators to still reduce their availability. Generators regularly schedule maintenance of their plant (including for valid reasons) and also regularly effectively withdraw capacity from the NEM as they rebid capacity into higher spot price bands, thus pushing up pool prices and eventually retail electricity prices. Care needs to be exercised to ensure that these tests are not susceptible to this type of behaviour.

There has been some suggestion that coal-fired generation plant may be retired early. The EUAA finds this argument difficult to sustain as generation in the NEM is dispatched according to merit order and this will continue even with the CPRS. Coal-fired generators will not close until they are displaced or undercut by lower emissions generators such as gas-fired electricity generation. In the meantime, they will still continue to be dispatched, earn a return for their shareholders and operate as usual. They will not close down overnight as it takes time to build new plant to push them down the merit order. As the Government has established a low trajectory in the first ten years of the scheme, the speed with which coal-fired generation is affected is also muted.

Is there a ‘sovereign risk issue’? This would have some merit if the failure to compensate discouraged new generation in the future. The strength of this would depend on whether the scheme is susceptible to frequent change and creates uncertainty about long-term investment.

The lack of compensation will not be an issue for lower emission plant as they are not going to be compensated anyway; and the carbon price and expanded RET will encourage new investment in renewable energy. In other words, this seems to only be an issue for existing coal-fired plant, which will eventually close anyway. We doubt that it would be an issue for the owners of this plant if they were to invest in new, lower emission technology for the same reason as stated above.

3.7.3 Compensation to households

In principle, the EUAA supports compensation to low income households who will suffer a disproportionate loss of disposable income as a result of the higher costs of goods and services after the imposition of emission prices.

The EUAA suggests that the compensation should include programs and incentives to improve the efficiency of household energy consumption. This should help to reduce demand for energy and hence reduce prices. However, we note that there are often significant inefficiencies and transaction costs associated with government-administered efficiency programs. This is a very important issue that the Government should take into account in deciding the compensation to households.

3.8 Enforcement and Penalties

There are a number of aspects of the enforcement and penalty regime upon which we comment below:

- We support the general approach to enforcement outlined in the Bill. We understand that the approach to be adopted will focus on “co-operative compliance” rather than more draconian steps. It would be useful to have some statement in the Bill, or by the Government, to this effect. This is especially important in the early years of the CPRS. We believe that some of our suggestions below are more consistent with “co-operative compliance” than the provisions of the draft Bills.
- The application of both make good and penalties in the early years of the scheme could be considered as excessive, given the ‘learning’ phase this entails. We would urge consideration of dropping one of these, probably the penalty, and applying only the make good provisions for say the first 3-5 years.
- Whilst we appreciate the Government’s desire to ensure that the CPRS is subject to appropriate penalties, we query the need to criminal penalties under this legislation and believe that affected parties should first be given the opportunity to demonstrate that there is no need for this. However, if criminal penalties are to apply, we do support restricting them to certain elements of the Bills.
- We would also urge a ‘go softly’ approach to enforcement in the early years of the scheme. Liable parties should be afforded a reasonable chance to get used to a new and significant obligation.

3.9 Independent Expert Review

The draft legislation provides for the establishment of a 3-5 person Expert Advisory Committee to conduct a strategic review of the CPRS at five yearly intervals. It also provides for public consultation, for the report to be tabled by the Minister and for a response by the Government within 6 months. We strongly support the need for such reviews and urge that they be:

- Undertaken by an independent committee;
- Have terms of reference that reflect the policy intent of the CPRS, including its environmental and economic objectives;
- Use transparent and public process, including the opportunity for submissions and public hearings; and
- That the reports, submissions and other input be made public.

3.10 Regulatory Authority

A new regulatory authority will be established under the CPRS. We strongly support the need for this authority to be independent and to have transparent operations. The members should also be appointed on merit and for what they know. The proposal to make a single authority responsible for the CPRS, the Renewable Energy Target and the NGERs is also strongly supported by the EUAA. It will be important for reports of the authority, including its Annual Report and audited accounts, to be tabled in Parliament and made public. The performance of the authority should be part of the five year strategic review of the CPRS.

3.11 Complementary measures

The Garnaut Draft Report suggests that *“a national emissions trading scheme must be the center-piece of Australia’s efforts to reduced greenhouse gas emissions”* and that *“pricing carbon, by itself, will not be sufficient to bring forth all the necessary innovation, particularly in the early years”*.

The EUAA agrees with the Garnaut Review’s view that an emission price should be the cornerstone of Australia’s emission reduction policy. However, very high emission prices may be needed to achieve substantial emission reductions. For example, the International Energy Agency suggests that to achieve a 50 per cent reduction on year 2008 emissions by 2050, the marginal cost of abatement would need to rise to between \$200 and \$500 per tonne.²

Such high prices may be politically unacceptable, and could have highly adverse implications for emission intensive trade exposed industries. In order to reconcile the need for emission reductions with the desire to limit the economic impact, complementary measures may therefore be useful, beyond their commonly accepted role in compensating for market failure.

For this reason, the EUAA suggests that there may be a role for complementary measures including building and product standards to reduce energy demand, energy efficiency programs, and policies to promote low emission electricity production. This is consistent with

² See IEA, *Energy Technology Perspectives 2008, Scenarios and Strategies*, 2008.

the purpose of the proposed Climate Change Action Fund, and also the broad scope of the compensation to households contemplated in the White Paper.

A critical issue will be how programs are funded. The EUAA strongly recommends that the Government should fund programs through the income that it will receive from the sale of emission permits. This should be extended not just to cover energy efficiency programs, but also to relieve the burden on users from the RET scheme.

Another important issue will be to ensure that such programs are well designed and administered so that they are effective in delivering good timely outcomes consistent with their objectives and in the most cost effective manner. It must be said that the track record of some other government programs is poor in this regard. The amount of money involved and the importance of the issue at stake make ensuring this even more important in the case of the Climate Change Action Fund and other financial initiatives. Regular scrutiny and independent review should also be a feature of such initiatives.