Business Council of Australia

Submission to

Senate Standing Committee on Economics

on

Exposure draft of the legislation to implement the Carbon Pollution Reduction Scheme

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EXECUTIVE SUMMARY

The BCA's vision is for Australia to be the best place in the world in which to live, learn, work and do business and for it to become and remain a top-five economy among OECD countries by 2012. The overriding objective is to enhance prosperity in Australia.

The BCA makes this submission giving consideration to Australia's long term economic prosperity, as it is the strength of Australia's economy and viability of Australia's businesses which will ensure we are able to respond to economic, social and environmental challenges including climate change.

The finalisation of legislation and the development of an implementation framework for the Carbon Pollution Reduction Scheme is occurring at a time of a sudden and severe downturn in the global economy which in turn has brought significant uncertainty about Australia's short-term economic outlook, with likely flow on concerns for example due to the terms of trade impact over the medium term.

In light of this, legislation for an emissions trading scheme and its implementation especially in the early years, will require a tailored approach which is aligned to the global and national economic conditions and designed to ensure Australia's industry and employment opportunities are not adversely impacted.

It has not been possible to fully consider the economic implications of the CPRS as many key elements remain unresolved and will not be available for review until the draft regulations have been provided.

INTRODUCTION

The Business Council of Australia (BCA) represents the Chief Executives of over 100 of Australia's leading companies. The BCA develops and advocates, on behalf of its Members, public policy reform that positions Australia as a strong and vibrant economy and society. The businesses that the BCA Members represent are amongst Australia's largest employers and represent a substantial share of Australia's domestic and export activity. Therefore they have a significant interest in the scope and direction of economic reform.

The BCA's vision is for Australia to be the best place in the world in which to live, learn, work and do business and for it to become and remain a top-five economy among OECD countries by 2012. The overriding objective is to enhance prosperity in Australia.

Such an objective is not at odds with effective environmental management. It will require the introduction of policies which lead to environmental costs and risks being taken into account and addressed in the most efficient manner. In the case of greenhouse gas emissions and the risks associated with climate change this can best be done through a market mechanism such as an emissions trading scheme.

However, the introduction of such reforms in the absence of a global response which includes Australia's competitor countries and in the current economic climate must be in a manner that does not disadvantage Australia's competiveness or put employment at risk, rather in a manner that ensures a smooth long term transition to a low emissions economy.

This submission highlights the policy framework which should underpin Australia's response to climate change and raises a number of issues which need to be considered as the CPRS design and implementation details are being finalised.

What is evident now, given the scale and projected duration of the global economic downturn and the severe and sudden deterioration in economic and financial circumstances in Australia is the need to not only get the details of the CPRS right but to calibrate the introduction and operation of the CPRS to ensure it does not exacerbate the impact of the economic downturn, impact on competiveness and employment or unduly slow the recovery in economic growth.

CLIMATE CHANGE POLICY DESIGN CONSIDERATIONS

In considering the policy frameworks that should underpin the response to the potential risks associated with climate change the BCA has been cognizant that a long term prosperous economy will be essential to dealing with the possible social and structural consequences of a transition to a low emissions economy. It also recognises the global nature of the emissions reduction challenge and the need for concerted international action by all major emitting countries.

Decisions related to climate change policy and action should be developed taking account of the following six critical considerations:

1. An effective, sustainable response to climate change is ultimately about moving from our current high-emission global economy, of which Australia is part, to a low emission global economy. This is a complex transition which will impact all nations and the communities and business of these nations.

2. The challenge of controlling emissions and hence climate change will be won or lost at a global level. Developing countries will likely contribute 70% of the growth in future world emissions, and will soon be the source of the majority of world emissions.

3. The most effective system to reduce emissions is one primarily based on a market solution. Market structures provide the basis for the identification of least cost solutions and build in the incentives to innovate.

4. Given the scope and scale of the transition implicit in effectively reducing emissions, a multi-faceted approach is essential. While a market-based solution is the primary vehicle, other supporting policies and initiatives will be required to ensure the research and development necessary to identify technology solutions including low emissions technologies, improve energy efficiency and build Australia's adaptation capabilities.

5. The necessity of a global-based solution does not mean Australia cannot make a significant contribution to such a solution, or demonstrate leadership by formulating responses that can be used as a template or guide for other countries to adopt.

6. Australia can and should implement strategies nationally which:

   - reduce emissions relative to a business-as-usual outlook;
   - ensure the abatement is that which is lowest cost;
   - include arrangements to address the impacts on emissions-intensive trade exposed industries in the absence of a global carbon price;
   - prevent adverse impacts on the competiveness of Australia's emissions-intensive trade exposed industries in the absence of a global carbon price;
   - ensure the risk of carbon leakage, that is the export of greenhouse gas emissions and related employment is prevented;
   - facilitate the long term and smooth transition of the electricity sector to low emissions technologies;
   - provide investment certainty to enterprises and investors; and
   - spread the costs of the transition to a low emissions economy, particularly as Australia acts ahead of other nations, across the community ensuring low income households are assisted.

The BCA has released a number of publications on climate change and emissions trading which address these matters in further detail. These publications are available at www.bca.com.au.

REVIEWING THE CARBON POLLUTION REDUCTION SCHEME EXPOSURE DRAFT

In December 2008, the government provided the final model of its CPRS and emissions targets for 2020. Subsequently on 10 March 2009 the government released the exposure draft legislation to implement the Carbon Pollution Reduction Scheme.

This submission reflects the initial review of the exposure draft and provides commentary on critical matters related to the drafting. It should be recognised that there has been a very short time frame in which to prepare this submission and the BCA will continue its assessment and commentary in coming weeks. In particular the taxation and accounting elements of the exposure draft have yet to be fully considered.

The table below highlights aspects of the exposure draft and initial BCA views.

Defining the Objects of the Act and parts of the Act	The objects do not fully reflect the government's stated policy intentions. The objects of the Act should be expanded to make clear the intentions of the Act also include: • putting a price on emissions • maintaining competiveness as well as addressing the risk of carbon leakage • offsetting asset value loss in the electricity sector • replacing other government policies and programs that do not support least cost emissions reductions • trigger/test for moving from 5% to 15% as emissions target The objects of part 8 should be broadened to make specific reference to offsetting competiveness impacts in individual industry sectors and having consideration for the measures implemented in those sectors in competitor countries. It should also include a specific reference that EITE transition arrangements will be maintained in an industry sector where international competitors do not introduce equivalent measures. The objects of part 9 should be redrafted to ensure this section provides for the offsetting of asset value loss in the electricity sector.
Setting 5 year caps and 10 year gateways Part 2	The Bill and related documents do not include reference to the process that will be used over time to share the national commitment between the CPRS and uncovered sectors. There is a need to define a range of matters referred to in this part. In particular it should be made clear what the tests will be for major economies and advanced economies. The grounds for the reference to consideration of voluntary action need to be made clear.
Safety cap Part 4 Division 2 section 89	The time limit on the price cap should be removed. The Part should include an object which specifies the role of the price cap and that it will be ongoing unless otherwise determined in the 5 yearly reviews.
Prohibition of sale of Australian emissions units Part 4 Division 3	Is it anticipated that this prohibition will be lifted when appropriate by amendment rather than by including a provision referring to this in the Act?

	There should be an additional section which states government will give a minimum of 5 years notice of a decision to lift the prohibition and the decision should be made following a review by the Productivity Commission which includes a cost benefit analysis of such linkage and analysis of the likely impact of the Australian price of permits as well as the range of other issues raised in the White paper.
Borrowing limits Part 6 Division 3	Section 130 (4) (b) limits borrowing of permits to 5% of the future vintage. The BCA proposes that this limit be increased to provide flexibility given the scope for annual fluctuations in emissions at an individual facility level eg taking facilities off line for extended periods for maintenance.
EITE arrangements Part 8	The Act should include the key policy principles and design parameters related to the eite arrangements. The objects of part 8 should be broadened to make specific reference to offsetting competiveness impacts in individual industry sectors and having consideration for the measures implemented in those sectors in competitor countries. It should also include a specific reference that EITE transition arrangements will be maintained in an industry sector where international competitors do not introduce equivalent measures. The Act rather than the regulations should also include the principles to be used to assess eligibility, rate of permit allocation, and process to be used for additional requests for assessment as an EITE.
Coal-fired electricity generation Part 9	The objects of part 9 should be redrafted to ensure this section provides for the offsetting of asset value loss in the electricity sector. Given the object of this section refers to the asset loss value in the electricity sector the quantum of assistance should not be limited and instead capped at a maximum level as reflected in the ACIL Tasman and ROAM modelling. Consideration of issuing 10 year forward dated permits should be considered. In respect of the proposed auctioning of permits, deferred payment arrangements and or the actual auction design should in the Act or regulation result in a situation where the CPRS does not impose any additional working capital burdens on scheme participants. The windfall gains test should be assessed against the 'net revenue' loss over the pre-CPRS expected life of the asset,

	rather than the proposed 15 year period.
Independent Reviews Part 25	It is proposed that these reviews be undertaken by the Productivity Commission or Panel membership include a Productivity Commission Commissioner with access to the expertise of the Productivity Commission. The matters to be reviewed should explicitly include: • reference to whether EITE arrangements are maintaining industry sectoral competiveness ; • review of what polices have been put in place in competitor countries in each industry sector to put a price on carbon; • review of electricity sector reliability; and • economic impact of the CPRS These provisions should be expanded so that an EITE individual company or industry sector can make an appeal for a review by the Panel to determine whether the provisions of the scheme will maintain competiveness at the level that existed prior to the scheme.
Tax and accounting issues Consequential amendments Bill	The BCA is still considering these matters.
Relationship with National and Energy Reporting System (NGERS) legislation	An initial review suggests that there will need to be changes to the NGERS to reconcile on matters such as reporting requirements, aligning NGERS with any changes following review periods. It is also proposed that NGERS be amended to such that in the early years (first 5 years) of the operation of the CPRS third party audits of large emitters be carried out in a staged manner so as to allow for building of competence and confidence and that after that external audits should not be mandatory but rather the Regulator require such audits on the basis of risk or suspicion of non compliance. The CPRS provides for the transfer of liabilities to the entity with financial control, however NGERS does not provide this flexibility. NGERS should be amended to provide a definition of operational control for the mining industry and allow the flexibility to commercially negotiate emissions reporting obligations.

It should be noted that this submission does not address a number of critical matters as the information is not yet available. These include:

- EITE activity definition, allocation (effective rates of) and operation of the transition arrangements
- Decay rate as it applies to EITE activities
- Impact of the renewable energy target on EITE industries unknown at this stage
- Auctioning process
- Availability of a deferred payment arrangement
- Treatment of permits and the implications of their status as financial products
- Excise tax adjustment related to fuel
- Processes for international linkage
- Operation of the Climate Change Action Fund
- Household assistance package.

A further outstanding matter is the treatment of coal mining. This activity was excluded from the EITE transition arrangements though it appears to meet the threshold tests. The reason given for this decision related to the range of emissions levels across the different mine sites.

Rather than excluding mining from the EITE arrangements the specific concern of the range of emissions levels should be addressed.

A related matter is that of scope 3 emissions where coal is an input into other EITE products.

Given the government's current intention is not to provide assistance for Scope 3 costs, including emissions from coal, there is a need to ensure whatever arrangements are put in place for coal mining do not lead to an increased cost pass through to those industries where coal is a key input.

The current proposal to provide coal mines with access to a limited pool of funds to address emissions reduction will not, of itself, address the risk of cost pass through. These funds are unlikely to offset all costs coal mines will face with the introduction of the CPRS, leading coal mines to seek recovery via cost pass through to EITE customers who, in turn, will not receive any assistance for Scope 3 costs.

Many critical elements of the CPRS will be included in regulations. Business will not be able to assess the full impact of what is proposed until it sees both the draft Act and related regulations. This brings into question the proposal that the Act be passed before the regulations have been considered.

With the implementation of the CPRS, businesses and households will face changes in their cost structures unless they are able to offset the direct and indirect impacts of the energy price increases.

For some businesses these costs will be substantial and addressing them will require investment to manage the impacts and reduce emissions.

The approach taken to EITE industries under the CPRS in the exposure draft does not totally offset the impacts of the CPRS on the competiveness of these industries and the inclusion of an annual reduction in permits available to these industries i.e. the decay rate is an additional impost on these industries who will already be purchasing between 10% and 40% of permits.

Overall, for EITE industries the combination of having to purchase 40% and 10% of their permits, the annual reduction in permits allocated and the increased price of carbon will still result in additional costs that they are unlikely to be able to pass onto their customers in the absence of key competitors facing a comparable carbon price. These additional costs on EITE industries will adversely impact their business operations, in some cases reducing competitiveness and returns.

Low emissions technology development and deployment in the electricity sector will be essential to ensuring Australia can contribute to global emissions reduction.

Whilst the exposure draft has provided mechanisms to support the transition of the electricity sector to low emissions technology it is of concern that the level of transition assistance described is unlikely to achieve this outcome without risks to reliability and supply of electricity and ensure an environment that facilitates new investment in electricity infrastructure.

Assistance to the electricity sector is required to ensure there is not an immediate reduction in generators' credit ratings and/or breaches of financial ratios (following on from the immediate loss in asset value) as this impact on the operations of the electricity market. It is worth noting that the number of Australian Emission Units (AEU's) with no charge applied to them for the entire electricity sector represents only 13% of its total greenhouse gas emissions, and less than a third of the asset value loss as forecast by two of the three modelling consultants appointed by Treasury.

Linked with this, coal-fired electricity generators face a potential requirement to source a material amount of additional working capital in order to fund the potential cash flows associated with the auctioning of permits. Particularly, in the current environment these additional funds may not be available and so any auction process should be designed such that any adverse working capital implications can potentially be eliminated. This may be achieved through a number of mechanisms including a deferred payment arrangement or through assigning a forward delivery (and settlement) date to permits auctioned.

The BCA is informed that there is approximately $5 billion of debt due to be re-financed between 2009 and 2012 by base-load coal-fired power plant in the NEM. The proposed change in law by the CPRS is likely to exacerbate the difficulty with re-financing this necessary infrastructure. The timing of the debt repayment, and cost of CPRS, may also cause difficulties for Directors of a number of electricity businesses as to whether or not they are a "going concern" (which in turn will affect their ability to trade). Connected with this, it is understood a number of electricity companies have recommended the Government underwrite the debt for all coal-fired power plant.

There are four further issues which are outside the boundaries of the exposure draft but will have a major impact on the costs and operation of the CPRS.

The first is the plethora of federal and state based programs related to emissions reduction and the take-up of alternative forms of energy supply which have the potential to reduce the effectiveness of the emissions trading scheme, increase regulatory and administrative burden of business and prevent the attainment of least cost emissions reduction.

The second is the need to remove electricity retail price caps which remains an outstanding issue and will become more important as the full cost of CPRS, renewables, energy efficiency and other initiatives unfold.

The third is the requirement for clear policies that facilitate ongoing investment and support for research and development efforts related to low emissions technologies.

Fourthly the process of review of state stamp duties through COAG has been delayed and as a result there remains ambiguity as the states capacity to charge stamp duty on permit related transactions.

It will be important to address these matters in parallel to the introduction of the CPRS.

What is evident now, given the scale and projected duration of the global economic downturn and the impact in Australia is the need to not only get these details of the CPRS right but to calibrate the introduction and operation of the CPRS to ensure it does not exacerbate the impact of the economic downturn or unduly slow the recovery in economic growth.

THE ECONOMIC OUTLOOK

The economic outlook has worsened since the release of the government's white paper both in terms of the depth of the economic decline and the likely duration.

The global economy has deteriorated rapidly and sharply, even compared with expectations in late 2008. Global growth contracted at an annualised rate of 5 per cent in the December quarter of 2008.

The most recent IMF forecasts are for a contraction of growth in the major advanced economies of between 3 and 3.5 per cent in 2009. This will be the first contraction in economic activity in those economies since World War II.[1] This compares with a forecast for growth of 1¼ per cent less than 12 months ago.[2]

Global growth is now projected by the IMF to contract by 0.5 to 1.0 per cent in 2009, compared with growth rates of 3¾ per cent in 2008 and 5 per cent in 2007. This is a very

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[1] International Monetary Fund (IMF), 'Advanced economies to contract sharply in 09, upturn next year - IMF, *IMF Survey Magazine*, 19 March 2009.

[2] IMF, *World Economic Outlook*, April 2008.

significant slowdown. In April last year, the IMF was predicting that the global economy would grow in 2009 at a still-healthy 3¾ per cent.

The United States, Japan, the United Kingdom and European Union are in recession. The economies of China and India are also expected to slow. Projections at this stage are for relatively modest reductions in growth, although more recent information provided by the IMF, OECD and the World Economic Forum suggests that China, in particular, may be slowing by more and much faster than expected.[3] This suggests that further downward revisions in economic forecasts around the world are likely.

Australia entered this difficult period from a stronger position relative to other countries on the back of seventeen years of sustained economic growth, record lows in unemployment, fiscal surpluses and low levels of public debt. The decline in GDP in the December quarter of 0.5 per cent demonstrated however that these strengths only provide a limited shield from the global situation.

Where just a year ago excessive demand was exposing Australia's supply constraints, we now find economic demand needs support. A significantly lower cash rate and the government's two major economic stimulus packages are significant policy responses to the downturn in demand.

IMPLEMENTING THE CARBON POLLUTION REDUCTION SCHEME

It is essential to address the outstanding design detail in the CPRS as discussed above.

In doing so, efforts must ensure the CPRS results in abatement that is lowest cost and that emissions-intensive trade exposed industries are addressed in a manner that does not see their competiveness changed in the absence of a global carbon price given the

[3] Between October and January 2009, the IMF revised downwards its 2009 forecasts for growth in China from 9.3 per cent to 6.7 per cent and for India from 6.9 per cent to 5.1 per cent. The OECD has warned of a 'strong slowdown' in China (OECD, 'Composite Leading Indicators Signal Deep Slowdown in OECD Area and Major Non-OECD Member Economies', news release, 12 January 2009, Paris).

flow on implications are likely to include reduced investment, carbon leakage and job losses.

Given the severe and sudden deterioration in economic and financial circumstances the CPRS should be implemented in a manner that does not expose business operations to excessive imposts. Rising capital costs and pressure on cash flows are now significant issues across business and will impact the capacity to manage the impacts of the CPRS. In this environment, additional uncertainty and risk will adversely affect investment decisions.

It will be particularly important to facilitate the smooth, long term transition of the electricity sector to low emissions technologies and to provide the basis for ongoing investment.

CONTACT

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