

The Secretary
Senate Standing Committee on Economics
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Dear Committee Secretary:

RE: Inquiry into the Carbon Pollution Reduction Scheme Bill 2009 and related bills

I would first like to thank the committee for the invitation to make a submission to this inquiry. I am grateful that through submissions to the various inquiries into the Carbon Pollution Reduction Scheme, I have had the opportunity to air my views as a private citizen on the overall shape of the scheme, and for the opportunity to provide further comment here. I will not waste significant time here in duplicating that effort, though as background to more specific critique of newer elements of the legislation, I will re-iterate that in my view, the Carbon Pollution Reduction Scheme, as it stands, is less than adequate when measured against various economic, environmental and international policy criteria.

I acknowledge that recent revisions to the CPRS mean that more environmentally acceptable targets are now part of Australia's position going into international negotiations in Copenhagen later this year. I heartily endorse this move, and the fact that it provides an incentive for international negotiations to move forward beyond the status quo. However, as pointed out by foreign policy experts, an effective and enduring response to the challenge of reducing greenhouse gas emissions is most likely to emerge out of national responses and their progressive integration into a global framework, not vice-versa. In this context, I would like to express in the strongest possible terms, my desire for legislation enacting the Carbon Pollution Reduction Scheme to be passed by parliament before December, as this is another significant action that Australia can take to promote an international agreement. There being no logical benefit to waiting for the completion of negotiations in Copenhagen before passage of the legislation through parliament, there remain only two arguments for delay of the Bills. The first is the valid criticism put forward by Senator Xenophon that a few months are required for further economic modeling, negotiations and amendments to the scheme. On the other hand, despite suggestions that Australia should see greater detail of a proposed US scheme before finalizing our own, I have heard no compelling arguments as to what purpose this would serve. Adopting a scheme similar to the US is only advantageous to the extent that it facilitates trade of permits between the schemes, and the existing CPRS is already well-suited to this purpose, almost regardless of the form of the US scheme.

Emissions quantity certainty and economic efficiency

As noted during the previous Senate Economics Committee inquiry into the CPRS legislation, the permit price cap mechanism strips the scheme of its most touted advantage – that of certainty of the quantity of emission reductions. Interestingly, however, research shows that the Government's

inclusion of a price cap in the scheme has a dramatic effect in improving the economic efficiency of the scheme over a pure quantity-based approach.¹

What is concerning about this, however, is that this quantity uncertainty property is asymmetric – that is, if emissions overshoot expectations, the emissions cap will be loosened, while if emissions undershoot expectations, the emissions cap will not tighten. Some have speculated that this property will lead to pressure on governments to periodically revise the cap. The use of fixed-price permits at commencement of the scheme addresses this issue for a limited time, however a better solution is simply to implement a price floor on permits. This would restore symmetry to the system, but would be far preferable to cap revisions from a simplicity and governance perspective, and is likely to reduce transaction costs through greater price certainty. The recent policy change to fixed-price permits at the introduction of the scheme also fits very well with this approach, providing a natural starting point for the price floor. The positive response to this policy innovation by various industry groups demonstrates industry’s likely willingness to accommodate a price floor.

Setting of Scheme caps and gateways and issue of fixed-price permits

The CPRS legislation, appropriately, allows the scheme caps and gateways to be set in the regulations, rather than requiring changes to the legislation. Curiously, however, the price caps – the prices at which permits may be purchased at a fixed price in Section 89 of the CPRS Bill – are specified within the legislation. If, however, Australia found itself in a position to adopt the 25% emissions reduction target, these price caps should also be revised to provide some semblance of confidence that the new target can be achieved, given that Treasury modeling predicts that emission reductions of 25% will give rise to permit prices above the price caps. Given the relationship between reduction targets and price caps, it would also seem appropriate for the Authority to make recommendations concerning price caps in the reviews described in Section 353 of the CPRS Bill. From this perspective, it would be sensible to specify fixed permit prices in the regulations – under constraints similar to those imposed on the scheme caps and gateways – rather than the legislation.

It is with significant concern that I note that the recent revisions to the CPRS bill have seen Sections 14 and 15, for the setting of scheme caps and gateways, changed such that the Minister “may” consider the reviews of the CPRS provided by an expert advisory panel under Section 354, whereas the exposure drafts made this compulsory. The notion that the Minister may choose, without fear of consequence, to ignore the important information contained in that review when considering future changes to the scheme is disturbing indeed.

EITES assistance

The recent increases to EITES assistance are of concern for a number of reasons. The mechanism for establishing allocative baselines for EITES determines the emissions intensity of an activity based on recent history prior to the introduction of the ETS.² This introduces an incentive for firms to overstate their emissions intensity (as, arguably, happened in Europe prior to their initial allocation of permits). New measures increasing assistance to 95% of the allocative baseline makes it highly likely that subversion of the assistance scheme in this way is possible. At the very least, independent

¹ Pizer WA (2002) Combining price and quantity controls to mitigate global climate change, *Journal of Public Economics* **85(3)**:409-434

² CPRS White Paper, Policy position 12.7, page 12-38

auditing of this process needs to be very strong, though it is unlikely that this was not seen to be the case in Europe. Therefore, one might consider using the surrender of permits during the first one or two years of scheme operation to establish baselines, during which time there is a balancing disincentive (the cost of the permit) to overstating emissions. This option does, though, suffer by promoting unintended *behavioural* changes, rather than simply anomalies in reporting.

The international effects of Australia's choice of EITES assistance scheme are significant. As noted during the previous Senate Economics Committee inquiry, upon maturation of global carbon pricing, removal of such trade barriers has the potential to pose significant challenges. While the policy position of government is to remove EITES assistance once a comprehensive, binding global agreement is in place, this will, in fact, be too late to prevent significant real subsidy to these industries, as highlighted in Prof Garnaut's discussion of the issue. **Error! Bookmark not defined.** Further, being left at the discretion of the Government and with no clear and binding definition of the "goal-posts" (ie the form of global agreement necessary to trigger this policy action), the removal of such assistance is open to the effects of organised lobbying.

I note that the previous inquiry acknowledges the theoretical benefits of Prof Garnaut's recommended solution to EITES assistance, but dismisses it on practical grounds. However, a reasonable proxy for Prof Garnaut's recommendation is relatively simple to implement, and is more transparent, clear and sustainable than the approach currently embodied in the CPRS legislation. Briefly, a fractional multiplier is incorporated into the formula for the allocation of EITES assistance, the multiplier representing the proportion of global trade in a given industry that is sourced from economic regions in which carbon pricing is not a component of the price of the good³. This would also bring the assistance scheme closer to the approach advocated in the Garnaut Climate Change Review, and reduce the burden placed on non-emissions intensive trade-exposed industries earlier. It imposes no additional burden on firms seeking assistance, with the multipliers for each industry being calculated periodically in an open and transparent manner by the Authority, in a manner similar to the functions of the Productivity Commission.

Governance issues

The auctioning of permits in the CPRS inevitably means that large volumes of revenue are directed back to Government, posing problems ensuring that these funds are used appropriately and with maximum environmental or economic efficiency. However, the European experience highlights the advantages of permit auctions in terms of avoiding over-allocation of permits⁴ at the outset of the scheme and in my view outweighs the governance issues associated with revenue recycling. The alternatives - "grandfathering" or free permit allocation - suffer equal if not greater governance issues in any case. Where possible, however, "fund-matching" measures which tie government funds to private decision-making should be favoured mechanisms for permit revenue recycling, beyond

³ A fictional illustrative example: Let us suppose that 10% of the world's aluminium is sourced from Europe, 20% from the US, the remainder from other areas of the world. At the outset of the scheme, the assistance to aluminium producers would be calculated as per the government's existing policy then multiplied by 0.9 since European aluminium incorporates carbon pricing, while the remaining 90% does not. If a US scheme was introduced, this multiplier would be reduced to 0.7, to reflect the further 20% of the world's aluminium that now incorporates carbon pricing. This would continue as more of the world's goods progressively reflect carbon constraints in their price.

⁴ when combined with the new \$10/tonne CO₂-e fixed permit price start

equity-driven cuts to personal and/or company taxes. For example, permit auction revenues could be used to match, to a limit, private investment in the electricity generation sector in place of the current coal-fired electricity generators assistance scheme. This would remove the perversity of the current assistance design, increase transparency, and prevent the government from “picking winners” – a particularly attractive element of the proposal since Governments are typically bad at identifying socially optimal forms of spending – while satisfying the stated aim of maintaining investor confidence in the sector and increasing security of supply.

Concluding remarks

The recent changes to the CPRS legislation make a significant step forward in offering incentives for international negotiations, and providing some hope, though slight, of Australia adopting emission reduction targets within the range of its global obligations. However, at the same time, it exacerbates existing problems with over-compensation of EITES industries and coal-fired electricity generators. It does nothing of consequence to address concerns about voluntary abatement, scheme complexity, or governance and sustainability issues. Still missing from the debate is a thorough and systematic sensitivity analysis of some of the key design aspects of the scheme. I urge the Committee to do everything in its power to ensure that these analyses are completed as soon as possible in order to clear the path for the legislation to pass through Parliament in time for it to make its contribution to the advancement of international negotiations in Copenhagen.

Yours sincerely,

Iain Murchland