

Chapter 4

Amendments to the price floor and access to international permits

4.1 As noted in chapter one, to facilitate the link to the EU ETS, the Australian Government has agreed that it would remove the price floor and restrict the quantity of eligible Kyoto units that liable entities can use to discharge their carbon liabilities.

4.2 For the most part, submissions were supportive of the removal of the price floor and the surrender charge on international units. Several submissions from clean energy and environmental groups expressed some reservations about the removal of the price floor, while acknowledging that the link to the EU ETS is a good alternative mechanism to provide certainty to the CPM.

4.3 Submissions were sharply divided on the amendments limiting the use of Kyoto units in the CPM and the introduction of the concept of ‘designated limits.’ Whereas a number of business and industry groups argued that sub-limits were inconsistent with the principle of least-cost abatement, other submissions noted that such limits were necessary to protect the Australian carbon price from falling too low to drive investment in clean energy.

Removal of the price floor

4.4 For the most part, submissions supported the removal of the price floor.

4.5 A number of submissions argued that the price floor would have potentially distorted the market, created inefficiencies, and imposed an administrative burden on liable entities. For example, IETA suggested its preference was for market-based mechanisms, and the proposed link to the EU ETS ‘was a lot more robust than what was previously proposed by the carbon price floor mechanism.’¹

4.6 Several submissions suggested that the removal of the price floor created a measure of uncertainty regarding the Australian carbon price. The Climate Institute argued that a gradually rising price floor has three beneficial effects:

1. it helps deter investment in highly emission-intensive technologies that would become stranded under the stronger policies needed in the future;
2. it reduces downside financial risk premiums associated with low carbon investments, thereby reducing the costs of such investments; and

1 Mr Emile Abdurahman, *Proof of Committee Hansard*, p. 24. Also see Business Council of Australia, *Submission 2*; Cement Industry Federation, *Submission 4*; Greenfleet, *Submission 5*; APPEA, *Submission 7*; Australian Financial Markets Association, *Submission 8*; COzero, *Submission 9*; ICAA, *Submission 10*; AGL Energy, *Submission 12*; Sustainable Business Australia, *Submission 14*; AIGN, *Submission 16*; and the Australian Coal Association, *Submission 17*.

3. it encourages investment in low emissions technologies through more predictable price signals. This brings down their costs through 'learning by doing' and economies of scale.²

4.7 While expressing a preference for an extended price floor, the Climate Institute acknowledged that a link with the world's largest market (that is, the EU ETS) was a good alternative, as long as it was combined with strong complementary policies for domestic clean energy and energy efficiency.³

4.8 The Clean Energy Council made a similar argument in its submission. While the removal of the price floor might reduce certainty for businesses making investment decisions and 'potentially lower the incentive for developing low-carbon technologies,' linking with the EU ETS is a 'good alternative' to the price floor:

It safeguards the Australian carbon price framework from future political pressure as repeal will now also mean severing connection to the world's largest carbon market. Furthermore, mutual recognition of carbon units between the two cap and trade systems sends the message that Australia is not acting alone.⁴

4.9 In its submission, WWF Australia noted that the possibility that there will be a price significantly lower than the former proposed floor underscored the importance of complementary clean energy policies, such as the Renewable Energy Target.⁵

The limit on Kyoto units and 'designated limits'

4.10 Business and industry groups were generally critical of the 12.5 per cent limit on the use of Kyoto units and the concept of a 'designated limit.' Such limits, it was argued, are inconsistent with the principle of least-cost abatement. Mr Dwyer, representing APPEA, underlined this apparent inconsistency for the committee:

It is certainly the case that the introduction of a possible range of sub-limits does seem to run against accessing permits as long as they are credible wherever they may be available. It seems strange to us to acknowledge that access to international markets is a positive development and then seek to then arrange ways to constrain that access.⁶

4.11 Mr Morris of the Australian Coal Association made the case that Australia, as a net buyer of permits, needs to access markets that need to sell permits. Yet the EU is also a net buyer of permits. In effect, this means that Australian entities will be restricted from freely purchasing permits from markets with lower marginal costs of abatement, and this will have the effect of making the EU carbon price the Australian price floor.⁷

2 Climate Institute, *Submission 1*, p. 2.

3 Climate Institute, *Submission 1*, p. 2.

4 Clean Energy Council, *Submission 3*, p. 1.

5 WWF Australia, *Submission 11*, pp. 6-7.

6 Mr Damian Dwyer, *Proof Committee Hansard*, p. 12.

7 Mr Peter Morris, *Proof Committee Hansard*, pp. 10-12.

4.12 In addition to the representations from APPEA and the Australian Coal Association, the committee received submissions expressing opposition to the limits on Kyoto units or the concept of designated limits from BCA, the Cement Industry Federation and Qantas.

4.13 Some submissions also suggested there is a lack of scrutiny in the amendments providing the Minister with the regulatory power to introduce new designated limits or change existing limits. For instance, AGL Energy suggested that providing the Minister with these regulatory powers would create uncertainty, increase risk premiums and thereby adversely impact on investment in low-carbon projects.⁸

4.14 On the same matter, the Cement Industry Federation suggested the government enshrine in legislation its commitment to neither introduce a new designated limit or change an existing limit without three years notice. Moreover, any such changes should be subject to greater public scrutiny, including analysis by the Productivity Commission.⁹

4.15 However, both AIGN and APPEA indicated they were satisfied with changes made to the legislation since the exposure draft was released, which limited the Minister's capacity to change designated limits with little notice (although APPEA reiterated that it would prefer the concept of designated limits to be removed altogether).¹⁰

4.16 By way of contrast, other submissions argued that it was important to maintain carefully considered limits on the importation of international offsets to prevent the Australian carbon price falling too low to drive clean energy investment. As the Climate Institute told the committee:

If you have no limit on Kyoto units and you have no price floor then the Australian price would have crashed, and it would have been a mechanism which we had gone through a whole bunch of pain to implement, which would not have driven the outcomes that we are already starting to see in the electricity sector and across the broader economy—that is, reducing emissions.¹¹

4.17 Similarly, the Clean Energy Council argued that the limit would ensure that the Australian carbon price was not set in the Clean Development Mechanism (CDM)

8 AGL Energy, *Submission 12*, p. 2.

9 Cement Industry Federation, *Submission 4*, pp. 6-7.

10 Mr Damian Dwyer, *Proof Committee Hansard*, p. 12; Mr Alex Gosman, *Proof Committee Hansard*, p. 12.

11 Mr Erwin Jackson, *Proof Committee Hansard*, p. 26.

market,¹² and safeguard against Australia's carbon price falling too low to encourage clean energy investment.¹³

4.18 IETA told the committee that the 'fundamental fact' is that Australia needs to have a 'level of domestic national ambition' for reducing emissions, and the price of CERs does not align to that level of ambition. Therefore, it 'makes eminent sense' that this is the way we will become linked to EU ETS and global markets.¹⁴

4.19 The committee also heard from DCCEE that while greater access to Kyoto units might help Australia meet abatement targets at a lower cost in the short term, this would not necessarily produce a least-cost outcome in the period beyond 2020. That is, unrestricted access to Kyoto units might undermine efforts to transition to clean energy and meet the longer term target of 80 per cent emissions reductions by 2050. As DCCEE told the committee:

The objects of the Clean Energy Act include to achieve Australia's international obligations and commitments—which, within those, would include our target range for 2020, to contribute to achieving an 80 per cent reduction in emissions by 2050 and also to encourage investment in clean energy—and to do this in a flexible and cost-effective way. So if you narrowed the target range down to 2020 only and you had no concern whatsoever about what happened after 2020, then access to Kyoto units, which are trading at very low levels at the moment—if those prices were to continue through that period, it may have that effect at 2020, but it may not set Australia up very well for the further emissions reductions that will be required to 2050 or for achieving the 80 per cent the reduction target.¹⁵

The credibility of Kyoto units and the 12.5 per cent limit

4.20 With regards to the CDM and the CERs it produces, the committee heard from Professor Frijters that the low price and credibility issues in the CDM market suggested 'a market in decline.'¹⁶

4.21 However, the Climate Institute told the committee that while there had been problems with Kyoto units in the past, the rules have become more stringent regarding the development of units. It further emphasised the importance of the Kyoto mechanism in developing the global carbon market and investment in clean energy.¹⁷

12 The CDM is a mechanism under the Kyoto Protocol that provides for emission reduction projects in the developing world. These projects generate Certified Emission Reduction units (CERs), a type of Kyoto unit which may be purchased by developed countries to meet part of their emission reduction commitments under the Kyoto Protocol.

13 Clean Energy Council, *Submission 3*, pp. 1-2.

14 Mr Emile Abdurahman, *Proof of Committee Hansard*, p. 30.

15 Mr James White, *Proof of Committee Hansard*, p. 37.

16 Prof. Paul Frijters, *Proof of Committee Hansard*, p.3.

17 Mr Erwin Jackson, *Proof Committee Hansard*, p. 30.

4.22 In its submission, COzero provided a strong endorsement of Kyoto units, stating that it 'believes in the integrity of credits generated through the Kyoto flexibility mechanisms and the additional social/economic benefits that many projects bring to developing countries.'¹⁸

4.23 In contrast to the views expressed by Professor Frijters, IETA argued that Kyoto units were a 'victim of [their] own success.' The number of units generated had proven far in excess of what anyone had expected, and with essentially only one market for these units to be utilised in – that is, the European Union – the price collapsed as a result of oversupply. The solution to this problem will come from 'the expansion of other emissions trading schemes that would be able to absorb those.'¹⁹

4.24 DCCEE assured the committee that Kyoto units 'are credible and reliable sources of abatement,' and noted that they are backed up by sound validation and verification processes. DCCEE further noted that 'the methodologies that are used to create them go through the CDM executive board, which makes decisions about the additionality of those methodologies.'²⁰

4.25 DCCEE told the committee that the 12.5 per cent limit on Kyoto units is not related to their reliability or credibility, but instead to the Government's position that Australia's carbon price should match or be similar to the carbon price that applies in most other developed countries that are operating market-based carbon pricing mechanisms. DCCEE did, however, allow that it was legitimate to raise questions about continued reliance on Kyoto units 'when the continued existence of those units depends on the international negotiations and also the extent to which the current price trajectories of Kyoto units may actually be sustained in the future.'²¹

Impact on revenue

4.26 The committee heard that the Treasury has not amended its projection of a \$29 per tonne carbon price in Australia in 2015-16. Treasury explained that:

...the fundamental assumptions in the modelling...have not changed in the sense that [the modelling] always envisaged Australia linking to credible international markets and was essentially a proxy for an international cost of abatement. I think we would regard the European scheme as the largest, deepest, most liquid market currently trading, as consistent with those modelling assumptions that were outlined.²²

4.27 Treasury further pointed out that because of the volatility in spot prices for carbon and even futures market expectations, Treasury tends to rely 'on longer term

18 COzero, *Submission 9*, pp. 1-2.

19 Mr Emile Abdurahman, *Proof of Committee Hansard*, p. 30.

20 Mr James White, *Proof of Committee Hansard*, p. 37.

21 Mr James White, *Proof of Committee Hansard*, p. 37-38.

22 Mr Robert Raether, Treasury, *Proof of Committee Hansard*, p. 39.

estimates rather than intermittent peaks and troughs that might come through with the spot market.²³

4.28 Treasury also pointed out that the:

...fundamental environmental targets and commitments that were embodied in the Treasury modelling have not changed. The modelling was based on commitments of 89 countries through the [United Nations Framework Convention on Climate Change] process to emission reductions by 2020. It assumed a long-term environmental target of stabilisation of atmospheric greenhouse gases of 550 parts per million. Those assumptions remain valid.²⁴

4.29 Professor Frijters expressed scepticism regarding Treasury's revenue projections. Drawing on projections produced by Deutsche Bank and Point Carbon, and taking into account the over-allocation of permits in the EU ETS and reduced economic growth in Europe, he suggested that 'revenue is going to be something like a third of what has been forecasted.'²⁵

4.30 Treasury acknowledged that economic growth in Europe is now projected to be somewhat slower than predicted at the time of the modelling. However, it was Treasury's view that what matters for carbon price projections from a modelling point of view 'is a very long-term outlook for world GDP growth,' and assumptions about long-term world GDP growth remain valid.²⁶ Treasury did, however, acknowledge that these are projections that refer to 'three years into the future with an internationally traded commodity where there are a lot of variables, so in that sense it is less certain than over the shorter term when the price is fixed.'²⁷

4.31 The Climate Institute pointed out that there is a broad spread of views on where the carbon price will be in coming years. The Climate Institute's own view is that the chance of the carbon price being under \$10 per tonne by 2020 has diminished, and it is more likely prices will be in the \$15 to \$20 by that time. IETA further suggested that, while the carbon price over the short-term might not be sufficient to drive sufficient investment in clean energy, a linked Australian CPM will serve as a mechanism to reduce emissions over the long term.²⁸

The role of the cap in determining Australia's aggregate emissions

4.32 Professor Frijters suggested that the likely low price of carbon under the arrangement made carbon abatement less likely:

23 Mr Robert Raether, *Proof of Committee Hansard*, p. 39.

24 Mr Benjamin Dolman, Treasury, *Proof of Committee Hansard*, p. 39.

25 Prof. Paul Frijters, *Proof of Committee Hansard*, p. 5. Also see Prof. Paul Frijters and Mr Cameron Murray, *Submission 6*, p. 1.

26 Mr Benjamin Dolman, *Proof Committee Hansard*, p. 40.

27 Mr Robert Raether, *Proof Committee Hansard*, p. 40.

28 Mr Erwin Jackson, *Proof Committee Hansard*, p. 29.

[T]he internal incentives in Australia to reduce carbon emissions depend directly on the price and, since that will be fairly low, the local impacts on innovation will be fairly minor as well and there will be certainly almost no knock-on effect within the European Union because it is expected that they are just going to sell us reserve permits if we buy any of them at all and the reserve permits are so enormous they already have three times more than our total annual usage in reserve permits that there is no pressure on their internal system from the meagre demand that we might actually put on their system.²⁹

4.33 In response, Treasury made the point to the committee that ultimately it is not the price of carbon that determines Australia's aggregate emissions so much as the cap, at least from 2015-16 onwards:

Aggregate emissions are fundamental to the scheme and are determined by the cap, and to the extent that the cap binds, and we would all expect it to bind, that determines Australia's aggregate emissions. It is the reduction in the cap that achieves Australia's emissions reduction target.³⁰

Committee view

4.34 The committee considers that the removal of the price floor will help facilitate the linkage of the Australian CPM to the EU ETS.

4.35 The committee acknowledges concerns expressed by some submitters regarding the 12.5 per cent limit on Kyoto units and the concept of 'designated limits'. However, the committee believes that some limit on Kyoto units is necessary to drive the transition in Australia to a low-carbon economy, consistent with the objectives of the CE Act.

4.36 The committee further notes that unlimited access to Kyoto units might create a higher long-term cost to the Australian economy in the transition to a clean energy future.

4.37 The committee acknowledges the need to establish provisions for the future introduction or setting of designated limits to, as the Explanatory Memorandum put it, provide 'flexibility in both setting and changing limits over time, reflecting maturation of Australia's emissions trading arrangements, the enhancement of existing links with overseas emissions trading schemes and the development of new links and international emissions trading systems.'³¹

29 Prof. Paul Frijters, *Proof Committee Hansard*, p. 5.

30 Mr Robert Raether, *Proof Committee Hansard*, p.41.

31 Replacement Explanatory Memorandum, p. 26.

