

Australia's Emissions Trading Scheme

THE GARNAUT CLIMATE CHANGE REVIEW

The Garnaut Climate Change Review (the Garnaut Review) has been commissioned by Australia's Commonwealth, state and territory governments to examine the impacts, challenges and opportunities of climate change for Australia. On 4 July 2008, the Garnaut Review released its *Draft Report*.

This follows the *Interim Report* and the *Emissions Trading Scheme Discussion Paper* released in February 2008 and March 2008 respectively. The Review's *Final Report* is due on 30 September 2008.

The Review is examining the impacts of climate change on the Australian economy, and recommending medium to long-term policies and policy frameworks to improve the prospects for sustainable prosperity.

Whilst recommendations are not generally made in the draft paper, indications are provided around the design features of an Emissions Trading Scheme (ETS). These require further consultation before completion of the *Final Report*.

The Draft Report can be down loaded at:

<http://www.garnautreview.org.au/CA25734E0016A131/pages/draft-report>

THE CARBON POLLUTION REDUCTION SCHEME

The publication of the Garnaut Review's *Draft Report* was followed on 16 July 2008, by the Australian Government's *Green Paper* on emissions trading entitled, *Carbon Pollution Reduction Scheme (CPRS) Green Paper*.

This *Green Paper* sets out options and preferred approaches for an Emissions Trading Scheme (ETS), such as which industry sectors will be covered and how emission caps will be set, as part of its efforts in developing a larger framework for meeting the climate change challenge.

The *Green Paper* also discusses ways to address the impacts on Australian households, emissions-intensive trade-exposed industries and other strongly affected sectors.

In addressing the preferred approaches for an ETS, and ways in which to address its impacts, the Green Paper makes clear reference to the Garnaut Review.

The Green Paper can be downloaded at:

<http://www.greenhouse.gov.au/greenpaper/index.html>

Submissions

There is a consultation process occurring and interested parties can make a written submission.

Submissions are due on or by 10 September 2008. These can be forwarded to:

Email: emissionstrading@climatechange.gov.au

Carbon Pollution Reduction Scheme Green Paper Submission
Department of Climate Change
GPO Box 854
Canberra ACT 2601
Australia

This Client Briefing summarises the key design issues raised in the *Green Paper*, draws comparison between it and the Garnaut Review's *Draft Report*, and provides some commentary to assist in understanding the impacts of issues raised.

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GREEN PAPER RECOMMENDATIONS	GARNAUT RECOMMENDATIONS	ENERGETICS COMMENT
<p>Key Terms Name: Carbon Pollution Reduction Scheme (CPRS)</p>	<p>Key Terms Name: Emissions Trading Scheme (ETS)</p>	
<p>National Target and Scheme cap</p> <p><u>Targets</u></p> <p>A decision on the <u>national medium term target</u> will be made at the end of 2008.</p> <p>A medium term national <u>target range</u> will also be announced for 2020 that provides upper and lower bounds to give investors and market participants info on directions and enables sufficient flexibility to be retained.</p> <p><u>Trajectories</u></p> <p>Guidance on the emission trajectory is proposed to be provided 5 years in advance, to be extended by one year every year to maintain a minimum of five years of guidance at all times.</p> <p><u>Scheme Cap</u></p> <p>The CPRS cap would be set and announced for a minimum period of 5 years in advance at any one time.</p> <p><u>Gateways</u></p> <p>The Government will provide guidance over future scheme caps beyond the initial certainty period through the use of a gateway in each of the following years, to the end of the gateway period.</p> <p>The initial length of the gateway will be 10 years beyond the minimum five years of scheme caps.</p> <p>Gateways will be extended by five years, every five years.</p>	<p>National Target and Scheme Cap</p> <p><u>Targets</u></p> <p>Per capita emissions are advocated as a guide for setting targets internationally in the medium term.</p> <p><u>Scheme Cap</u></p> <p>Emissions limits should be expressed as a trajectory of annual emissions targets over time, which define long term budgets</p> <p>Five years notice should be provided by Government before movement to another trajectory.</p> <p><u>Gateways</u></p> <p>The Garnaut Review proposed a variation on the gateway concept; four trajectories that should be specified upon establishment of the scheme. The first, up to 2012, will be based on Australia's Kyoto commitments. The other three for the post-2012 period reflect increasing levels of emission cuts.</p> <p>Movement between them should be based on determining the comparability of Australia's response to international effort.</p>	<p>National Target and Scheme Cap</p> <p><u>Key terms</u></p> <p>A 'target' or 'economy wide emissions limit' describes national emission reduction goals at a future point in time.</p> <p>A 'cap' or 'emissions limit' describes the ceiling on emissions placed on participants in the ETS (CPRS) only.</p> <p>A 'trajectory' describes how we get to the target over time.</p> <p>A 'gateway' is a potential range within which future scheme caps may be set under the scheme.</p> <p><u>Targets</u></p> <p>It is important to recognize that a national target will not be the same as a CPRS cap. It is however likely that these will be similar in terms of the trajectory of reductions required.</p> <p><u>Scheme Cap and trajectories</u></p> <p>A CPRS cap and trajectories will determine the volume of permits available on the market and this in turn will affect the carbon price achieved; too many permits will lead to a price collapse, and too few permits to a price spike.</p> <p>The Green Paper and the Garnaut Review propose a system that allows the government to retain flexibility to respond to international negotiations, climate science and observed impact of the scheme on emission levels.</p> <p>Both the Green Paper and the Garnaut Review propose that the market is informed 5 years in advance of any change to the trajectory.</p>

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<p>Scheme coverage (who is liable to buy permits)</p> <p><u>Gases</u></p> <p>All six greenhouse gases will be covered under the scheme</p> <p><u>Facilities</u></p> <p>Facilities producing more than 25,000 tCO₂-e</p> <p><u>Sectors</u></p> <p>Broad sectoral coverage is advocated including:</p> <ul style="list-style-type: none"> ▪ Stationary energy sector – both direct emitters and fuel suppliers; ▪ Fugitive emissions – direct emitters; ▪ Industrial processes – direct emitters; ▪ Synthetic gases/refrigerants - bulk importers of gas and equipment filled with gas; ▪ Transport - upstream fuel suppliers will be obliged to buy permits and will pass on the permit price to consumers; ▪ Waste sector – threshold to be determined; and ▪ Forestry companies can opt-in to the scheme if they want to create credits. <p>Sectors excluded from buying permits:</p> <ul style="list-style-type: none"> ▪ Agricultural sector emissions (reviewed in 2013); ▪ Emissions associated with deforestation; and ▪ Fuel exported, fuel used for international transport, sequestered in plastics and supplied to visiting defence forces and consular vehicles. 	<p>Scheme coverage</p> <p><u>Gases</u></p> <p>All six greenhouse gases should be covered under the scheme</p> <p><u>Facilities</u></p> <p>Facility thresholds are not recommended but the Review notes that in determining points of obligation, these should be imposed where transaction costs are lower (one buyer not many) and where there is a greater certainty on the accuracy of emissions measurement.</p> <p><u>Sectors</u></p> <p>Sectors recommended to be included from scheme commencement:</p> <ul style="list-style-type: none"> ▪ Stationary energy; ▪ Industrial processes; and ▪ Fugitive emissions from fuel production and transport. <p>Sectors recommended to be transitioned into the scheme as soon as practicable:</p> <ul style="list-style-type: none"> ▪ Waste; and ▪ Forestry. 	<p>Scheme coverage</p> <p><u>Facilities</u></p> <p>NGER captures facilities with total 25,000 tCO₂-e Scope 1 (direct) plus Scope 2 (indirect) emissions.</p> <p>CPRS will capture facilities with 25,000 tCO₂-e of Scope 1 emissions only. So coverage under NGER does not automatically mean liability under the CPRS.</p> <p><u>Sectors</u></p> <p>Both the Green Paper and the Garnaut Review are broader in coverage when compared to other existing or emerging schemes, e.g. the European Union emissions trading scheme and the New Zealand emissions trading scheme.</p> <p>Broad coverage is important in equalising the effort required across the economy; if the scheme covers a smaller number of participants it limits the opportunities for reductions, and drives the cost of the scheme higher than broader coverage.</p> <p><u>Points of obligation</u></p> <p>In some sectors the point of obligation is proposed to be different under the CPRS and the National Greenhouse and Energy Reporting Act, 2007 (NGER) e.g. transport fuels and synthetic gases where upstream suppliers are liable.</p> <p>The Green Paper prefers use of the operational control boundary for determining which party is obliged to buy permits, as this is consistent with the approach taken under NGER. Considerable issues exist for companies in the interpretation of operational and overall control, as defined in NGER Act and Regulations for some types of facilities.</p> <p>The Green Paper states that in determining the best framework for establishing the liable entities, the Government will consider options that reduce compliance costs and minimise implementation risks.</p>

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<p>Price cap</p> <p>A cap will be placed on the price of carbon for the first 5 years of the scheme.</p> <p>Modelling would be used by Government to establish the likely permit price and the price cap would be set above this point.</p> <p>Given the price cap will be set above the expected price, it is anticipated that the price cap will be utilised by companies only in exceptional circumstances.</p>	<p>Price cap</p> <p>A cap is supported as a transition measure for the first 2 years.</p> <p>A penalty price is proposed as a price cap, as it sets the point at which companies will choose not to purchase permits and pay the penalty instead.</p> <p>A 'make-good' provision is recommended to ensure that companies, whose emissions exceed permits retired, are required to both pay a penalty and acquit additional permits for the shortfall.</p>	<p>Price cap</p> <p>Depending on the level of the price cap set, there are a range of consequences to be considered including:</p> <ul style="list-style-type: none"> ▪ Liable parties may choose to pay the set price and not engage in the process of trading; ▪ Financial institutions may be less motivated to establish trading facilities, thereby reducing the emergence of a secondary market. A secondary market is important to ensure there is liquidity and price discovery in the market. ▪ A price cap may prevent linking to international markets.
<p>Compensation / transition measures</p> <p>No credit to be granted for early action abatement (as proposed previously) due to the limited timeframe to establish a system for project approval and the difficulty in establishing a fair measure for project additionality.</p> <ul style="list-style-type: none"> ▪ Strongly affected industries (largely coal-fired generators) <ul style="list-style-type: none"> ○ Assistance will be provided to workers and regions in the form of structural adjustment payments; ○ Funds for investment in CCS research and technologies will be provided; and ○ Some limited assistance will be provided to coal-fired electricity generators via a new mechanism called the Electricity Sector Adjustment Scheme (ESAS). ▪ Emissions-intensive trade-exposed industries (EITEs) <ul style="list-style-type: none"> ○ Up to 30% of permits should be allocated freely to EITE activities; ○ Assistance should be determined on the basis of the industry-average emissions intensity for an 	<p>Compensation / transition measures</p> <ul style="list-style-type: none"> ▪ Strongly affected industries <ul style="list-style-type: none"> ○ \$1 - \$2 billion fund to support new investments that reduce emissions in coal-fired generation; and ○ No direct compensation for loss of asset value; ▪ Trade exposed emissions intensive industries (TEEIs) <ul style="list-style-type: none"> ○ Sets out a 3 step plan for Government to deal with the problem of formulating policy to deal with TEEIs: <ol style="list-style-type: none"> 1. A Global Deal on Emissions targets needs to be established 2. Global Sectoral Agreements for these sectors where possible 3. Until these Global Agreements are in place domestic assistance of up to 30% of the total permit value may be justified for assisting the trade-exposed sector; ○ Assistance should not be calculated firm-by- 	<p>Compensation / transition measures</p> <p>The loss of early action incentives should not discourage business from acting early as any reductions made now are an avoided future cost of permits. Also compensation is likely to be based on industry average emissions intensity, not facility by facility, so more efficient processes will be better positioned once the CPRS commences.</p> <p>The challenge for the Government in finalising the proposed compensation and transition measures will be to balance the requests of a variety of industry groups and individual companies while still ensuring the scheme's viability. They will need to ensure the proposed compensatory and transitional measures are:</p> <ol style="list-style-type: none"> 1. Affordable (ie. covered by the revenue generated from the auctioning of permits; and 2. Assist in the real reduction of emissions <p>With regard to the EITEs:</p> <ul style="list-style-type: none"> ○ Determining the boundaries for this group will be a political challenge. ○ There is a risk that the level of compensation

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<p>activity which would be tightened over time; and</p> <ul style="list-style-type: none"> ○ Assistance would be withdrawn in the event of acceptable international action. <ul style="list-style-type: none"> ▪ Transport <ul style="list-style-type: none"> ○ Fuel taxes will be cut on a cent for cent basis to offset the initial price impact of the CPRS to: motorists; on-road business users; and heavy vehicle road users. This will be reviewed every 3 years for the first two categories and after the first year for the latter. ○ The effect of the permit liability on businesses in the agricultural and fishing industries (and indirectly rural and regional areas) will also be compensated through the use of additional rebates. ▪ Households <ul style="list-style-type: none"> ○ Low income households will receive increased payments via the welfare and tax systems; and ○ All households will receive support in the form of new energy efficiency measures and information. 	<p>firm but rather for each industry as a whole and only those that are at “genuine risk of large and excessive reductions in domestic emissions”.</p> <ul style="list-style-type: none"> ▪ Transport <ul style="list-style-type: none"> ○ Discussion of increased costs and impact on households (as the end consumer) only – no written comment on reductions in fuel excise as a compensatory measure. ▪ Households <p>Approximately half the proceeds from the sale of all permits could be allocated to households</p> 	<p>required for this group will impact the point at which a cap will be imposed; the cap may exclude this group.</p> <ul style="list-style-type: none"> ○ Compensation based on industry-average intensity will advantage those operations that are more efficient and drive less efficient operations to improve. ○ Better than average standards should be established for new facilities. <p>With regard to the assistance for coal-fired generators:</p> <ul style="list-style-type: none"> ○ The experience in the EU ETS saw the generators passing on the costs of carbon to customers despite the assistance they had received. This led the generators receiving substantial windfall profits
<p>Auction revenue</p> <p>Every cent raised for the Australian Government from the scheme will be used to assist households and businesses adjust to the scheme and to invest in clean energy options. Specific measures include those discussed above in relation to compensation including:</p> <ul style="list-style-type: none"> ▪ Climate Change Action Fund – for business transition and also for affected workers and communities ▪ Support for low and middle income households including welfare payment increases and tax cuts, provide assistance for middle income earners and provide additional support through the introduction of energy efficiency measures 	<p>Auction Revenue</p> <p>The Report proposes that all of the revenue be returned to households or business:</p> <ul style="list-style-type: none"> ▪ Half of the permit revenue should be returned to the household sector ▪ Up to 30 per cent of permit sales revenue could be returned to the business sector as payments to trade exposed firms ▪ Twenty per cent of the permit revenue should be allocated to support for research, development ▪ Commercialisation of low emissions technologies ▪ Cash reserves should be used to purchase international permits/ offsets to reconcile 	<p>Auction Revenue</p> <p>The Government will need to deal with a range of demands on the auction revenue from companies seeking to be included amongst those that receive free permits or other compensation. There is a risk that the majority of the funds will be spent on buying support for the scheme rather than the revenue being used to support carbon mitigation and efficiency improvements where they can have the biggest impact.</p> <p>Energetics is keen to see that Change Action Fund receives a large amount of the auction revenue and is designed in such a way as to help the business transition to a low carbon economy. We will be providing input to Government on the areas they have identified for the fund, which are:</p> <ul style="list-style-type: none"> ▪ Capital investment in innovative new low emissions

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<ul style="list-style-type: none"> ▪ Electricity Sector Adjustment Scheme ▪ Support for emissions-intensive trade-exposed activities 	<p>domestic emissions with international commitments.</p>	<p>processes;</p> <ul style="list-style-type: none"> ▪ Industrial energy efficiency projects with long payback periods; and ▪ Dissemination of best and innovative practice among small to medium sized enterprises.
<p>International linking</p> <ul style="list-style-type: none"> ▪ It is proposed that Australia's ET units not be exported in the initial years of the scheme; this could generate unnecessary volatility while the scheme is bedded down. ▪ Subject to restrictions, the scheme would enable linkage through use of the Kyoto Protocol flexibility mechanisms – namely the Clean Development Mechanism and Joint Implementation. This would be available in the early years of operation only; entities would be able to meet their obligations by using Kyoto units for compliance in the scheme, limited to a maximum percentage of each entity's obligation. 	<p>International linking</p> <ul style="list-style-type: none"> ▪ An effective international global agreement to limit the risk of climate change will need to cover two main areas: <ul style="list-style-type: none"> ○ The quantum of mitigation effort needs to be agreed (global target); and ○ Mechanisms for international collaboration (global trading and funding) ▪ The number of international offsets should be limited to a fixed proportion of Australian permits. 	<p>International linking</p> <ul style="list-style-type: none"> ▪ Linking with international markets will create a more liquid market, with clearer price signals, than a domestic market alone. ▪ To the extent that it is permitted, companies with operations internationally may find it more economic to implement reduction projects overseas and import the permits to meet the Australian liability. ▪ Distinctions need to be drawn between direct bilateral (where two governments recognise units from their respective schemes) and unilateral linkage (where a government recognises units from another scheme but this is not reciprocated); and indirect linkage (through the import/export of Kyoto Protocol mechanism units). It is direct bilateral linkage that will be the greatest assistance in the development of a global carbon market and price. To move toward such linkage, the design of the CPRS must already take into consideration how this might best be facilitated in the future.
<p>Complimentary measures</p> <ul style="list-style-type: none"> ▪ The Government has inherited a collection of policy measures and programs which have evolved over the past 11 years. Ratification of the Kyoto Protocol, and more importantly the commitment to implementing the CPRS, has fundamentally shifted the policy environment. ▪ Key complimentary measures discussed include the 	<p>Complimentary measures</p> <ul style="list-style-type: none"> ▪ There are potentially large and early gains from better utilisation of known technologies, goods and services, including energy efficiency and low-emissions transport options. ▪ Some combination of information, regulation and restructuring of contractual relationships can address many of the market failures blocking 	<p>Complimentary measures</p> <p>Australia's energy use is currently growing at a rate of more than 2% every year. Energy efficiency is being overlooked as a major piece of the carbon solutions strategy. There is an expectation that the carbon price set by the emissions trading scheme will help to drive businesses to improve their energy efficiency. A price on carbon is an important market signal and very effective for directing longer term investment decisions in energy supply infrastructure.</p>

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<p>need to:</p> <ul style="list-style-type: none"> o Drive mitigation in sectors not covered by the scheme; o Support and drive research, development and demonstration of new technologies where the investors are unable to capture the full benefits of their investment; o Address other market failures such as non-price barriers; and o Inform and educate. <ul style="list-style-type: none"> ▪ The Wilkins review will assess whether existing programs and election commitments are complementary to the CPRS, identify gaps where new policy might assist and recommend the phasing out of inefficient programs. ▪ States and territory governments are encouraged to discontinue their market based programs once the CPRS commences. 	<p>optimal utilisation of proven technologies.</p> <ul style="list-style-type: none"> ▪ The Review will consider the various policy interventions that might reduce the costs of market failures related to information externalities and principal-agent problems and provide clear recommendations in the final report. 	<p>However it may not be the only tool required for changing shorter term energy consumption patterns. If the carbon price is set low and large emitters given free permits there will be little chance that the ETS will drive energy efficiency.</p> <p>Energetics believes that additional complimentary measures focused on driving energy efficiency are essential for reducing emissions.</p>
<p>Offsets</p> <ul style="list-style-type: none"> ▪ The scheme's broad coverage leaves limited scope for domestic offsets. ▪ Forestry companies will participate in the scheme so that credits generated from new forests may be recognised within the scheme. ▪ Participating entities will be able to purchase Kyoto units for compliance purposes, subject to restrictions. These will be limited to a maximum percentage of each entity's obligation. The units allowed to be used will be Certified Emission Reduction Units (CERs) from the Clean Development Mechanism and Emission Reduction Units (ERUs) from the Joint Implementation mechanism. 	<p>Offsets</p> <ul style="list-style-type: none"> ▪ Domestic offsets would have a small role given broad coverage. ▪ Unlimited use of offsets is proposed for the forestry sector ▪ Offsets from non covered sectors may be generated only where these meet additionality requirements. 	<p>Offsets</p> <ul style="list-style-type: none"> ▪ The ability to create credits through projects verified under the Greenhouse Friendly scheme will become limited upon scheme commencement to the forestry sector. ▪ In general, the market for such credits will most likely remain with entities not covered by the scheme who are voluntarily acting to offset their emissions ▪ It is likely that interest will grow in Certified Emission Reduction certificates from the Clean Development Mechanism.