The impacts of the proposed Emissions Trading Scheme

Australian Carbon Pollution Reduction Scheme

On 16 July 2008 the Federal Government unveiled its green paper on carbon pollution reduction which included plans for an emissions trading scheme, entitled the Australian Carbon Pollution Reduction Scheme (**CPRS**), to be implemented in 2010.

There are 5 trading schemes already operating in Australia: MRET (national scheme), VRET (Victorian scheme), NSW GGAS (New South Wales scheme), ACT GGAS (ACT scheme) and 13% Gas Scheme (Queensland scheme). A new VEET (Victoria Energy Efficiency Target) scheme is due to commence in Victoria on 1 January 2009 and New South Wales and South Australia plan to introduce their own versions called NEET and REET, also from 1 January 2009. The CPRS is intended to replace NSW and ACT GGAS and potentially the 13% Gas Scheme.

The Government faces a growing stream of criticism from industries which do not qualify for the Government's proposed compensation measures under the CPRS including liquefied natural gas (**LNG**), petrol refining, aviation, paper production and companies that import synthetic greenhouse gases (in bulk and in appliances). It is expected that companies not covered by exemptions or compensation measures will lobby the Government heavily prior to the announcement of a legislation package in about December this year.

The Government's Treasury modelling of the impacts of the proposed CPRS has been delayed to October – a month after the 10 September deadline for industry to provide its feedback on the green paper. Opposition Treasury spokesman Malcolm Turnbull has criticised the Government's consultation timetable saying, "Treasury's modelling will not be ready until October, perhaps even November … Companies with thousands of Australian jobs and billions of Australian dollars at risk will be asked to write one of the most important submissions in their history in the dark."

It is widely anticipated that the general cost of living and the cost of doing business, especially the provision of goods and services, will increase under the proposed CPRS. While the Government is treading very carefully - all too aware that households and small businesses already struggle with record oil prices and rising interest rates - Australian businesses are calling for a total "user-pays" approach to passing on the costs of the CPRS to minimise adverse effects to profit margins.

Mel Staley reports on the impacts of the CPRS, with a focus on energy and transport.

SNAPSHOT

The Government's green paper proposes a CPRS comprising two arms – a carbon pollution cap and the ability to trade. In summary, the mechanics of the CPRS are:

- The Government will set a carbon cap allowed for the national economy in relation to the affected sectors.
- The Government issues a limited number of carbon permits up to the cap.

- A permit is required for each tonne of greenhouse gas emitted.
- The quantity of carbon pollution for each firm will be monitored and verified.
- A permit for each tonne of greenhouse gas emitted is surrendered at the end of each year.
- Firms compete in the market to purchase the number of permits that they require.
- Firms that value the permits most highly will be prepared to pay the most for them, either at auction or on a secondary trading market. For some firms it will be cheaper to reduce emissions than to buy permits.
- As a transitional assistance measure, certain categories of firms might receive some permits for free. These firms could use the permits or sell them. There are a limited number of free permits available.
- The price of permits is not subject to regulation but rather dictated by the market.

Under the CPRS "greenhouse gases" includes all six types of emissions identified by the Kyoto Protocol including carbon dioxide (CO_2), methane (CH_4), nitrous oxide (N_2O), sulphur hexafluoride (SF_6), hydrofluorocarbons (HFCs), perfluorocarbons (PFCs).

The Government proposes that emissions from stationary energy, transport, industrial processes, waste, and fugitive emissions from oil and gas production will be subject to the CPRS. The CPRS should cover around 75 per cent of Australia's emissions and apply obligations to around 1,000 entities.

10 KEY COMMITMENTS

The Government has stated that it subscribes to the following commitments:

1. **Investing in households and economic growth** – Every cent raised from the CPRS will be used to help Australian businesses and households to adjust to the scheme and to invest in clean energy options.

2. **Cent for cent offset in fuel price impacts -** Fuel taxes will be cut on a cent for cent basis to offset the initial price impact on fuel associated with the introduction of the CPRS. The Government will periodically assess the adequacy of this for three years and adjust this offset accordingly.

3. **Increasing payments to pensioners, carers and seniors -** People in receipt of pensioner, carer, senior and allowance benefits will have their payments increased above automatic indexation and will be provided other assistance to meet the overall increase in the cost of living flowing from the scheme.

4. **Helping low-income households -** Assistance to other low-income households will be increased through the tax and payment system to meet the overall increase in the cost of living flowing from the scheme.

5. **Helping middle-income households -** Assistance will be provided to middle-income households to help them meet any overall increase in the cost of living flowing from the scheme.

6. **Reviewing and improving assistance measures -** The adequacy of payments to beneficiaries and recipients of family assistance to help with the overall impacts of the scheme will be reviewed annually in the Budget context.

7. **Ramping up energy efficiency -** Additional support will be provided through the introduction of energy efficiency measures and consumer information to help households take practical action, reduce carbon pollution and save money on energy bills.

8. **Supporting heavy vehicle road users -** For heavy vehicle road users, fuel taxes will be cut on a cent for cent basis to offset the initial price impact on fuel associated with the impact of the CPRS. The Government will review this measure after one year.

9. **Creating the Climate Change Action Fund -** The Climate Change Action Fund (**CCAF**) will be set up to assist business transition to a cleaner economy. The CCAF will provide partnership funding for a range of activities, including:

   - Capital investment in innovative new low emissions processes
   - Industrial energy efficiency projects with long payback periods
   - Dissemination of best and innovative practice among small to medium sized enterprises

10. **Keeping the energy industry strong -** A limited amount of direct assistance will be provided to existing coal-fired electricity generators to ameliorate the risk of adversely affecting the investment environment. The Government intends to deliver this assistance, in part, through the new Electricity Sector Adjustment Scheme.

ENERGY AND ELECTRICITY

Despite the planned permit concessions, modelling released on 25 July 2008 commissioned by the Energy Supply Association of Australia (**ESAA**) found that the Government's emissions reduction targets could trigger the premature closure of almost a quarter of the electricity generating capacity on the eastern seaboard.

The Government plans to cut greenhouse gas emissions by 60% by 2050 and the ESAA modelling found that if emissions are slashed by 20% on 2000 levels by 2020, major coal-fired power stations would be forced to close in Victoria (3 operations), South Australia (all operations), Queensland and New South Wales (1 operation each). Assuming those closures occur, the ESAA modelling found that meeting the growing demand for energy, as well as complying with the Government's renewable energy generation targets would require capital investment of about $36 billion over the next 12 years. The ESAA modelling also found that the Government's plan to have 20% of electricity generated from renewable sources by 2020 could add an extra 5% to the bills of end-users in real terms.

The Government's green paper has taken up a number of the recommendations made in the Garnaut Review Draft Report (**Garnaut Report**) but there are a few major differences. In particular, the green paper includes a proposal to provide compensation for coal-fired power plants by way of free permits. This was not entirely unexpected, however it is completely at odds with the Garnaut Report which maintained that there is no environmental or economic reason for compensating coal-fired power plants and that to do so would be a purely political measure.

On 23 July 2008 the *Australian Financial Review* reported that Woodside Petroleum chief executive Don Voelte had warned that more than $60 billion in planned LNG investment could be scrapped because the CPRS penalises exports of the clean gas. Under the proposed CPRS aluminium smelting and other highly emissions-intensive processes would receive 90% of permits for free and slightly less intensive activities would receive 60% of permits for free, based upon how many tonnes of carbon are emitted for every $1 million of revenue. Other companies with relatively clean operations would receive no assistance at all. The rate of greenhouse gas emitted by LNG processes may not be enough to qualify them for free permits and they will have to purchase 100% of the permits they need to operate which some argue would put that product at a disadvantage. Under heavy pressure from business Prime Minister Kevin Rudd has confirmed he will hold consultation on the “carbon intensity” benchmarks and has indicated that it is open for negotiation.

What is clear and consistently repeated by the Government is that the pool of free permits available will be limited and the reduction targets fixed so that the more concessions that are granted to one sector, the more other sectors will be required to take up the burden of the CPRS. This means some businesses will be forced to deliver solutions which lower carbon emissions. The oil and gas company Santos has recently announced a venture into gas–fired electricity generation to benefit from the increasing demand for cleaner energy.

In a closely related issue, energy companies are appealing to the State Governments to scrap retail electricity price caps, warning that price regulation together with the CPRS is a lethal combination for companies that are not insulated to some extent by investments in energy generation assets that would give them an alternative source of energy, such as AGL and Origin.

Energy companies are concerned that price increases on the national electricity market linked to the CPRS could trigger a similar situation to that seen in California in 2001 when energy retailers were paying more for wholesale electricity than they were able to charge customers under price caps. Wholesale spot prices soared but price regulation prevented those costs being passed on which in turn lead to insolvency and the public rescue of several utilities.

On 23 July 2008 the *Australian Financial Review* reported that Austelectricity chief executive Simon Draper said that if carbon prices were not passed on to the consumer, “that would have the impact of unwinding over a decade of competition reform, basically a whole lot of players would be squeezed out of the market.”

Some major industry players have cautioned that price regulation imposed by the states could completely frustrate the aims of the CPRS and potentially discourage investment in energy assets by impeding the pass-through of carbon costs to end-users. Many businesses argue that the Government should not shield consumers from the price signals associated with the CPRS, particularly as such protection would undermine the price signals that emissions trading schemes are designed to introduce.

New South Wales Minister for Energy Ian Macdonald has asserted that the costs associated with emissions reductions requirements would be able to be passed through to the customer under New South Wales retail price determinations because there is a provision for an annual review of wholesale prices to be included in the regulated price determined by the Independent Pricing and Regulatory Tribunal. New South Wales prices already include a pass-through of the cost of the current New South Wales Greenhouse Gas Reduction Scheme.

Queensland’s Mines and Energy Minister Geoff Wilson has declared that Queensland will maintain regulated prices (referred to as “uniform tariffs”) because otherwise consumers in remote and rural areas would find power unaffordable. Mr Wilson has argued that it is feasible to maintain retail price caps because the Queensland market has already been opened up to multiple retailers who are able to compete under the maximum price cap. However, Queensland’s rural and remote areas are also heavily subsidised by the Queensland Government which provides a community service requirement to Ergon Energy, worth $650 million in 2007/08, to subsidise the cost of supplying electricity to the bush.

Transport

The trucking industry has been hard-hit by the effects of the recent rise in fuel costs. To ease the effects of involvement in the CPRS, the Government announced it would provide a cent-for-cent fuel tax offset for the heavy vehicle road users. This measure appears to be at odds with the recommendations of the Garnaut Report however the Government has decided to run with it for one year and then review the situation.

The rail industry has taken issue with the policy rationale of subsidising the trucking industry, arguing it puts rail at a competitive disadvantage in relation to freight and passenger rail transport, which are more greenhouse friendly options. It seems that the result is likely to be that the cost of rail passenger and freight transport will rise while the cost of road transport will remain the same.

Transport Minister Anthony Albanese has defended the treatment of transport, saying that it is critical for it to be included in the system, and has pointed out that the comparative position of rail transport would be vastly improved if proposed measures to change cost-recovery arrangements on heavy road vehicle charges had not been blocked in the Senate by the opposition.

Qantas Airways, which recently asserted that an emissions trading scheme could raise the price of oil by $35 a barrel, has joined the growing list of companies concerned about the impact of the CPRS. The Government’s green paper provides that airlines should pay for 100% of their permit obligations, unlike other emissions-intensive sectors. Qantas’s chief executive Geoff Dixon has claimed that under the CPRS its domestic operating costs would increase by about $100 million.

The increased operating costs for airlines are expected to be passed on to customers. Unless the airlines are able to participate in the allocation of free permits, there will be a significant increase in costs for companies using air transport in conducting business. The broader tourism industry is also likely to suffer a downturn as a flow on effect. Qantas is seeking discussions with the Government.

Transport is responsible for about 15 percent of the nation’s greenhouse gas emissions. Mr Albanese plans to convene a round table discussion with the transport sector next month to provide a forum for the road, rail, aviation and shipping sectors to have an input.

Governance

The green paper argues that “political accountability suggests that elected representatives (the parliament and the Government) should be given responsibility for major policy decisions which require the balancing of broad environmental, economic and social considerations and which have far-reaching implications”.

The current proposal is that reduction targets will be set annually by the Government, depending on a range of issues including international impacts. Parliament would oversee the setting of targets and would have the power to overturn the minister's decision each year, which would result in the escalation of lobbying pressure on politicians to slow down the CPRS and create more exemptions, compensation or concessions.

So far the institutional arrangements for setting and implementing caps are unclear. Earlier discussion papers, such as the Garnaut Report, had envisaged a Reserve Bank of Australia-style system in which the Government set medium-term reduction targets, like the RBA's inflation target, and then set up an independent carbon regulatory authority to manage short-term adjustments.

A spokeswoman for Climate Change Minister Senator Penny Wong has said that the green paper position on governance "is expressly a preferred position, not a final decision" and the Government plans to consult with all stakeholders before finalising it. The Government will not yet confirm whether the setting of the annual emissions cap and trajectories will be the responsibility of parliament as proposed. There are growing concerns that this would fuel populist annual lobbying.

To date the Government's attention has been focussed on determining which industries would come within a CPRS and the extent of compensation provided to trade-exposed and emissions-intensive industries. Although the Government has said that the targets and estimates contained in the green paper are subject to negotiation, ministers are insisting that no more than 30% of permits will be given away.

The Government has emphasised that business assistance will have to decline over the medium term for the CPRS to be effective. Senator Wong has stated that broadening concessions to industry could only come at the expense of other companies being fully exposed to a carbon price.

The draft legislative package for the CPRS is scheduled to be announced by the Government in December this year. The Government plans to introduce a bill into Parliament in March 2009 with the legislation planned to be in force and a scheme regulator established by the third quarter of 2009. The actual trading scheme is scheduled to commence in January 2010.

For more information, visit the Government's website: http://www.greenhouse.gov.au/

What they said

"We do actually want the community to engage very closely with this issue", Climate Change Minister **Senator Penny Wong** on why the Government has launched a $10 to $20 million CPRS advertising campaign. *Australian Financial Review*, 21 July 2008.

"My main concern is that business doesn't seem to be aware of the consequences of the population rise and there's no discussion about it", **Dr Bob Birrell**, director of the Centre for Population and Urban Research at Monash University. *Sydney Morning Herald*, 23 July 2008.

"Consumers aren't getting the price signals that the schemes are designed to introduce", **Grant King**, Managing Director of Origin Energy on the Government attempting to impede the passing on of carbon cost to the market. *Australian Financial Review*, 23 July 2008.

"The process of passing through costs and incorporating into the retail price determinations will be far easier in NSW than in some other states as NSW already does this for [the Greenhouse Gas Reduction Scheme], and is well prepared to do so for the [CPRS] as [the Greenhouse Gas Reduction Scheme] is transitioned into the [CPRS]", NSW Minister for Energy **Ian Macdonald** on passing on costs of the CPRS to end-users. *Australian Financial Review*, 23 July 2008.

The executive director of the Energy Retailers Association of Australia **Cameron O'Reilly** said that eliminating retail electricity price capping is "one difficult thing that the states have to do to make it work". *Australian Financial Review*, 23 July 2008.

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