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Minister for Climate Change and Energy Efficiency
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Dear Minister Combet,

Following the NGO Roundtable on Climate Change meeting last Friday, we are pleased to respond to your request for a short statement on our views regarding carbon price design.

Support for Emissions Trading Scheme

We strongly support a market-based mechanism in the form of an emissions trading scheme (ETS). The *cap* and *trade* elements of an ETS are the key reasons why it is the superior carbon pricing mechanism:

- the *cap* provides certainty of environmental outcome, the primary policy objective. It also provides certainty of the framework for investors. Investors seek 'certainty of rules' rather than 'certainty of price'. A cap for 2020 creates certainty of the future trajectory of prices, provided that the rules regarding supply of permits over that trajectory period are known. This allows the market to estimate supply and demand of permits and make price forecasts accordingly, just as occurs in other markets.
- the *trade* provides private sector incentive and ability to keep costs as low as possible. Evidence from the Grattan Institute and others, including personal experience from working in London's carbon markets, shows that market participants will discover new and cheaper solutions, and Governments consistently fail to predict the way the market will achieve a given objective, generally overestimating the costs. Also Governments often underestimate consumer take-up, such as in the recent examples of solar rebates and some other household programs. Allowing the market to respond in its own way is widely recognised as a more economically efficient mechanism than a fixed price or fixed solution predetermined by Government.
- We acknowledge that a transition period from a fixed price to floating price mechanism may be necessary in the current political environment. Given the clear benefits of a cap-and-trade scheme, we strongly urge the Government to:
 - keep any transition period to a minimum, no more than two years;
 - ensure than any fixed price mechanism is done through the architecture of the ETS that will become the market mechanism after the fixed period. Businesses should only be asked to understand and implement one set of rules, and these rules should be those of the permanent system not the transition system. That means, for instance, that a fixed price is achieved through ETS permits being made available at a fixed price, rather than a tax

or levy being introduced in a separate legal form for the transition period and then a new ETS starting;

- ensure that the fixed price rises each year of the transition period, to show the future direction of the price trajectory;
- ensure that fixed price permits cannot be banked for later use;
- create default rules up front for how the transition occurs to the floating market, so that there is certainty about what happens after the two-year period
 - For example, the default position being the ETS legislation and rules commence on 1 July 2012, with permits being made available at a fixed price for two years, and then the floating price ETS commences with the cap being at least 5% below 2000 (ideally higher), with an agreed process (via rules to be determined this year) to consider setting the cap higher, based on science.
- Ensure that the process for setting the cap in 2020 and beyond is based on science. We know from the IPCC work that this means a reduction of 25% - 40% below 1990 levels for developed economies. Anything less than this will make future costs much higher for Australia's transition to a low carbon economy, as well as fail to play our part in achieving the necessary global targets. We also know that achieving a 25% reduction below 2000 levels is achievable in Australia with technology already available: a key finding from the *Low Carbon Growth Plan for Australia* is that this is possible and at a lower cost than many expected (a net annual cost to society of around \$185 per household in 2020).
- If the cap is lower than 25%-40% initially, then there should be some limitation on the volume of international offsets that can be used in the Australian ETS. With unlimited international offsets allowed, the ETS will likely struggle to achieve its purpose as described by you of being an economic reform to enable our economy to prosper in a low carbon world. Under a low target with the ability to source cheaper permits from outside Australia, very little abatement activity is likely to occur in Australia, denying our economy the investment to help transform supply chains, skills, risk management and asset creation that is key to achieving the necessary economic reform. (In the EU ETS, the level of imports is capped at around 13% effectively for the current Phase 2 period.)

Alternative methods (carbon tax, baseline and credit) are sub-optimal

Based on the above views, it is self evident that we do not support the other models outlined in the papers circulated to the NGO Roundtable. The absence of a cap in those alternatives is a fundamental weakness – not only does it fail to provide environmental certainty as to abatement outcomes (and abatement is the primary objective of the policy action), it also fails to provide long term investment certainty. This is because fiscal measures (such as a tax) are inherently uncertain given that they can be overturned by Governments and are subject to annual budget pressures, and also because short term price certainty is not sufficient for investors in long-term assets such as low-carbon energy generation assets that will provide the step change in Australia's emissions profile.

Other measures such as Baseline and Credit and target intensity schemes suffer from the additional disadvantage that they do not raise funds that can be used to assist low income households adjust to the carbon price and increasing energy costs. They are therefore inequitable as low-income households spend a higher percentage of their income on energy and are most vulnerable to an increase in energy bills. It is likely that the political risk for government will increase if there is not revenue available to assist these low-income households and this could further jeopardise the scheme overall.

Managing impact on household electricity prices:

In addition to the carbon price design considerations, we consider it essential to successfully address the issue of rising electricity prices. The majority of the forecast rises in the near term is *not* due to the introduction of a carbon price but to other factors including increased network costs (driven at least in part by peak load), new generation, and increased fuel costs. However if we are to achieve our carbon reduction targets, an obstacle may be community opposition to rising prices. Therefore we urge the Government to explore all ways to reduce future price rises, particularly through reducing consumption and avoiding or deferring increased investment in electricity network infrastructure by better managing the rise in peak demand. Some of the key measures in this regard include:

- Implement the Energy Saving Initiative (ESI) recommended in the Prime Minister's Energy Efficiency Task Group. This should be implemented in conjunction with, not separate from or later than, the carbon price mechanism.
 - It is a key measure in its own right, as evidenced by our research in the *Low Carbon Growth Plan for Australia* (2010), that over 50 million tonnes of GHG abatement is financially profitable now but is not being undertaken, revealing that non-price barriers exist and hence it will not be responsive to a price-based incentive such as a carbon price. Our research, which was awarded a Eureka Prize in 2010, found that a carbon price is necessary but not sufficient for transforming our economy. In addition our research found that energy efficiency measures dramatically reduce the overall cost of abatement. Specifically, of the 54 actions we identified as least-cost measures to achieve a given level of abatement, the net annual cost to the economy was \$1.8 billion in 2020 (approx \$4 per household per week), but if the energy efficiency measures are not achieved, the total cost is \$7.3 billion p.a. in 2020.
 - Also the ESI can help households lower their electricity bills in a lasting way, unlike any one-off or short-term fiscal support that might be offered in a Household Assistance Package. This is particularly useful given that the carbon price element of any future price rise will only be a small component of the total price rise: it will apply to the wholesale (generation) cost which is around 40% of total cost. Transmission and distribution costs comprise 50% of households bills with retail comprising approximately 10%.
 - Further, the ESI can (and should, at least initially) contain a requirement that a large proportion (eg 25% or 50%) of the 'white certificates' that are created must be sourced from low-income households. This has been the situation in the equivalent scheme in the UK since its inception.

- A national ESI is likely to be more efficient and attractive to retailers given that there are different schemes now operating in different states potentially adding to costs.
- We acknowledge that the detailed rules for an ESI would take some time to finalise. This could be managed by announcing a firm commitment at the time of the carbon price agreement to delivering an ESI, which would commence at the end of the fixed price period, when the floating price ETS begins. This would give the Government two years to finalise the details and work with the States to transition the existing schemes into a national one.
- Peak demand reduction measures
 - Soaring peak demand is a major contributor to rising electricity prices, and this will not be addressed by a transitional Household Assistance Package. Rather, under current NEM rules, there is almost unbridled incentive for increased costs, because peak demand is becoming 'peakier' and a regulated return on capital is offered to ensure that supply meets demand. The current NEM rules mean that when increased use of air conditioners, for example, causes increased peak demand, the regulatory tools such as annual Statements of Obligation show suppliers how much extra capacity is needed and there is a defined process for including the costs of constructing that extra capacity in customers' future bills. This is effectively a regressive system: those purchasing air conditioners are causing system-wide increased costs but those costs are spread across all energy market customers, including those who can't afford air conditioners and those who design or insulate their homes to reduce or avoid the need for air conditioners.
 - These energy market issues are broader than the carbon price reform, and hence need broader solutions than whatever transitional assistance will be provided out of carbon price revenue. They were well illustrated by Drew Clarke, DRET Secretary, in his presentation to the NGO Roundtable last week. However we were disappointed to hear in response to our question that the Government is not undertaking analysis for how to reduce the 'peakiness' of the rising peak demand and how much in financial terms could be saved in avoided costs by deferring the need for future network upgrades. We understand from other studies that the savings are extremely substantial. We urge the Government not to passively accept this market situation, but to acknowledge the market failure and create the incentive for those potential costs to be avoided.
 - There are a range of measures to address this, including: tariff reform (eg time-of-day pricing; inclining block tariffs; other variations that can be enabled by smart meters); decentralised energy generation; vastly improved appliance standards and other regulatory measures some of which can be drawn from the successful integrated programs to reduce water use.

Complementary measures are vital

- An integrated approach is necessary – a carbon price, complementary measures including other market mechanisms such as the RET and ESI as well as regulations to rapidly improve the emissions standards for buildings, vehicle and appliances, including industrial equipment. In addition the Government should be supporting the integrated approach by leading by example: higher procurement standards, improved building stock and vehicle fleet management. These actions not only help improve the Government’s credibility and avoid claims of hypocrisy, but also play a significant role in educating and mobilising supply chains across all the relevant product areas, offering a real world ‘learning by doing’ experience for suppliers and healthy competitive tension for high value Government contracts, that in turn gives certainty to low-carbon suppliers who can finally scale up their businesses.

Finally, we were pleased to note your suggestion of establishing a Communications Working Group at the NGO Roundtable. As we have noted at each NGO Roundtable meeting, a strong communications effort from Government is critical to success. The members of the NGO Roundtable are well placed to assist the Government in disseminating information to their stakeholders. Accordingly we would be pleased to assist the Communications Working Group to prepare easy-to-use information packs that can be circulated alongside the Government’s own communications efforts.

We look forward to continuing to work with you throughout this year to achieve the historic – and urgent – reform of a carbon price and energy efficiency measures. We have not included any comments on issues of compensation or use of carbon price revenues, as we understand that will be addressed in the next stage.

Yours sincerely,



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