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Ms Anthea Harris
Chief Executive Officer
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Dear Ms Harris

AUSTRALIAN INDUSTRY GROUP SUBMISSION TO THE CAPS AND TARGETS REVIEW ON THE DRAFT REPORT

The Australian Industry Group welcomes the opportunity to respond to the Climate Change Authority's draft report on its targets and progress review. Since we made our initial submission to the review, the Australian policy context has changed significantly. In particular, the new Government is committed to removing the policy framework of carbon pricing and emissions caps that had been a large part of the basis for the review.

However, we recognise that the Government remains committed to a range of emissions targets for 2020; that it is in the process of undertaking a second set of commitments under the Kyoto Protocol, consistent with the unconditional -5% target; and that the Government will consider emissions commitments for the period after 2020, likely in the lead up to the 2015 Conference of the Parties to the United Nations Framework Convention on Climate Change.

The questions raised by the review thus remain highly relevant, and we look forward to further refinement of the approach to these issues. To that end, Ai Group has some additional input.

Principles

Ai Group has developed strong principles for sound climate policy over our many years of engagement with this issue. These principles, endorsed by our National Executive, are reproduced in full at the **Attachment**. While they focus on domestic policy design, the first principle is:

Australia should ensure that its emissions reduction effort is in line with the action and ambition of other major economies.

This includes taking into account the extent to which major emerging economies are constraining their emissions and whether efforts by advanced economies are comparable to our own.

Australian climate policy should be flexible so that it can be adjusted in response to the actual level of emissions reduction action and ambition in major advanced and emerging economies.

For example, weaker action or ambition in these economies should lead to lighter burdens on Australian business. Conversely, policy should be able to strengthen if warranted.

Australia should develop and promote a credible basis for assessing and comparing the efforts of different countries. Regular reviews are needed.

Thus our principles call for the sort of exercise the Authority is now conducting, and for this exercise to be repeated and refined in light of changes in, and better information about, climate action and commitments by other nations.

However, it is important that this review exercise consider international emissions commitments and relevant policies in greater detail in the final report than in the draft. The presentation of information in Appendix B on climate policy measures is useful, but wider coverage and a higher level of detail on individual measures would be even more useful, as would more clearly presented data on the actual emissions performance (and, more speculatively, future projections) for major economies and the world as a whole. This would allow better assessment of the ability or intent of key economies to make good on their existing emissions pledges. In some cases national policies exceed international commitments, suggesting those targets may be more than met; in other cases, a lack of substantive policy suggests targets either will be missed or require no effort. The Authority's conclusions would be stronger if this greater level of detail were developed or made explicit.

Such an exercise should remain focussed on issues important to the question of Australia's national commitments. In particular, while the question of the effective carbon price or constraint faced by relevant trade exposed industries in relevant economies is extremely important to the design of Australia's domestic climate policies and the distribution of policy burdens, it is not the most relevant metric for calibrating national commitments. While intuitively high effective carbon costs would appear to be a marker of strong climate commitments, in practice the detail of domestic policy design is extremely important. A commitment to deep targets can coexist with a policy design that shields trade exposed sectors from the associated costs, while a modest emissions commitment implemented with a different policy design could expose traded sectors to extremely high burdens.

Consistent with the principle of calibrating climate effort to the actual and evolving level of international action, the Authority should also give additional thought to the issue of the 2°C goal and consistent emissions budgets. All countries are formally committed to the goal of ensuring that global average surface temperatures do not increase by more than 2°C from

preindustrial levels.[1] However, it is very widely acknowledged that current emissions commitments from all nations are collectively inadequate to achieve this goal, even if headline pledges are assumed to be met.[2]

While international climate negotiations are an iterative process, and future rounds may lead to commitments consistent with the 2°C goal, there is a very serious possibility that commitments remain inadequate for this objective. The world may effectively pursue looser, though still challenging, goals, to constrain temperatures at levels above 2°C. That would have serious implications for Australia in terms of risk and adaptation requirements, but it would also imply a different notional global carbon budget to define Australia's fair contribution against. While such scenarios are troubling, they need to be fully considered if the review is to provide the best input to policy. The Authority has provided guidance on Australian emissions budgets consistent with the 2°C goal. It should also consider other outcomes, such as 2.5°C and 3°C, and the carbon budgets, mitigation and adaptation requirements associated with them.

Domestic policy design

Industry's caution with respect to climate policy has always been related to its potential economic costs and to its impacts on the competitiveness of trade exposed industry. As suggested above, these costs depend at least as much on policy design as on ambition. A wide range of potential options exist globally to reduce emissions, sequester carbon, or acquire recognised emissions entitlements. Without considering transaction costs, practical problems and policy limitations, the costs of any particular emissions target could be relatively low. If policy forecloses some portion of available options, either by expressly excluding them or by imposing excessive costs and barriers, the overall costs of meeting the target will be higher.

International opportunities for emissions reduction, sequestration and trade in entitlements are particularly important. This is because the opportunities are so large, cheap and well demonstrated. Certified Emission Reduction (CER) credits issued under the UN Clean Development Mechanism (CDM) are currently selling for around $0.50 per tonne. These units are produced by an offsets scheme comparable in some ways to the Government's proposed Emissions Reduction Fund and the existing Carbon Farming Initiative, and are legally valid for use in meeting Australia's Kyoto Protocol commitments. Their low price is attributable both to very strong supply from projects in China and India, and to reduced demand from a European market that is on course to meet its emissions targets much more easily than anticipated. A high level review of the CDM in 2012 made a number of recommendations for improvement, but found the market to be of great value to global

[1] Though some, notably small island states, hold out for even more challenging goals such as a 1.5°C limit.

[2] See for example Ecofys, Climate Analytics and the Potsdam Institute for Climate Impacts Research, 'Climate Action Tracker' (November 2013) http://www.climateactiontracker.org/.

mitigation efforts and declared increasing demand to be the most important step.[3] While low prices have greatly slowed new project development, the supply of CERs is extremely strong; around 10 billion are likely to have been issued by 2020.[4]

As the draft report recognises, the availability or otherwise of these international units makes a very big difference to the costs of any target. This can be illustrated very simply. The Authority's analysis and modelling suggests that the gap between business as usual (BAU) emissions and the -5% 2020 target is a cumulative 593 million tonnes to 2020, while a -15% or -25% target would require a further 305 or 609 million tonnes of abatement.[5] If we consider three representative abatement costs – the current CER price of $0.50 per tonne, an average European Emissions Trading Scheme carbon price to 2020 of $10, and a representative average domestic Australian abatement cost of $50, we see the following very simplified, purely indicative cumulative abatement costs.[6]

	-5% (593mt)	**-15% (898mt)**	**-25% (1,203mt)**
CER ($0.5)	$296.5m	$449m	$601.5m
EU ETS ($10)	$5,930m	$8,980m	$12,030m
Domestic ($50)	$29,650m	$44,900m	$60,150m

Table 1 - illustrative cumulative abatement cost to 2020 under different targets and prices

These numbers should be used with caution, since BAU is uncertain and the cost of domestic abatement is highly contested.[7] However they illustrate that a policy that made use of low cost CERs to achieve a 25% target could cost around a tenth of a policy that used EU emissions allowances (EUAs) to achieve a 5% target. Using EUAs to achieve a 25% target could cost less than half achieving a 5% target with domestic action alone.

[3] CDM Policy Dialogue, *Climate change, carbon markets and the CDM: a call to action* (September 2012) 3 http://www.cdmpolicydialogue.org/report/rpt110912.pdf.

[4] See the database maintained by the Institute for Global Environmental Strategies: Kentaro Takahashi, Akihisa Kuriyama and IGES Market Mechanism Group, 'IGES CDM Project Database' (December 2013) http://pub.iges.or.jp/modules/envirolib/view.php?docid=968.

[5] The BAU number is contested; some have made larger or smaller estimates based on different views of future economic growth and electricity demand. It remains a reasonable starting point.

[6] The CER price could imaginably recover, though this would require very large increases in demand or reductions in supply. This risk suggests the importance of stockpiling CERs sooner rather than later. The European price to 2020 will depend heavily on 2030 targets that are yet to be articulated, as well as on any pre-2020 reforms to the EU Emissions Trading Scheme. However market analysts currently expect prices to average around AUD$10 to 2020 (a significant rise from current prices of around AUD$7). $50 is roughly the average to 2020 in the high price scenario in Treasury's 2011 carbon price modelling; this could be used as a proxy for domestic-only abatement costs, though even in that scenario about half the abatement to 2020 was sourced from overseas.

[7] It should also not be taken as an indication of total costs under the Government's Emissions Reduction Fund, since budgeted spending under that program is capped at already-announced funding levels. If the spending caps are reached, under existing commitments abatement purchasing would cease.

Implications for policy and targets

There are two major implications from the analysis above.

Firstly, the use of international abatement options is vital to controlling the costs of Australian climate policy. The Authority's draft report recommended that the Government make use of international units as part of any effort to go beyond the -5% target. Ai Group strongly supports this recommendation, but it does not go far enough. While the Government's existing position is to achieve the -5% target solely with domestic action, the cost differential between local and international abatement is so great that it would be sensible to include overseas opportunities in the policy mix. This is exactly what Ai Group has separately recommended to the Government.

We propose that the Government establish a reserve of international units outside the Emissions Reduction Fund auction process using a portion of the funding notionally budgeted for the ERF. This should be large enough to cover the gap between BAU emissions estimates and the -5% target. At current CER prices, and depending on different estimates of BAU, this would require between $140 million and $300 million, out of an ERF budget of $1.55 billion over the forward estimates and up to around $5 billion to the end of 2019-20. The establishment of the reserve could be handled by the Government directly, but could perhaps better be delegated to the same independent entity that will manage the ERF, presumably the Clean Energy Regulator. The reserve should be established sooner rather than later – with CER prices so low, there is relatively little downside risk. It would then be available for use either to bridge any gap to the -5% target or, if domestic activities deliver the 5% goal, to greatly reduce the cost of any future decision on deeper targets for 2020 or beyond.

A second implication – and critical to Ai Group's response to the draft report – is that it is impossible adequately to describe the potential costs of any given target without knowing important details of the policy design that will meet it. While the minimum cost of any given target could be relatively low with full access to domestic and international abatement opportunities and an efficient scheme design, the actual costs could be very much higher to the extent that policy design closes off options or adds to abatement costs. In our original submission to the Authority, Ai Group indicated that under a fully internationally linked emissions trading scheme a deeper target would not increase burdens on industry and hence would not be a serious concern, subject to the very important caveat of the maintenance of the international link. However, there is no longer sufficient clarity on the domestic policy context to make such a judgment.

Given this, Ai Group does not support the consideration of any targets beyond the current unconditional -5% goal until such time as there is much greater clarity about Australia's domestic policy design, including its openness to international options. The Government's commitments to policy development and consultation suggest that this clarity should emerge through the course of 2014. However it is unlikely to exist before the Authority is required to complete the current review. The Authority should consider updating its analysis in light of further information, including domestic developments and information about international policy and emerging post-2020 commitments, if it has the opportunity.

A summary of Ai Group's responses to key draft recommendations is below.

Draft recommendation	Ai Group response
2020 emissions reduction target, 2013-20 carbon budget and trajectory range to 2030.	Do not support any decision on additional targets at this time. Target decisions should await greater certainty on domestic policy design and ability to deliver any abatement target at least cost.
National budget to 2050	This is a useful concept and should continue to be considered and refined. It would be helpful to also present alternative budgets based on different core assumptions around the global goal for containing climate change and the basis for division of effort.
Using international emissions reductions	Strongly support recommendation to use international units as part of any effort to meet deeper targets. However international units should also be part of efforts to meet the unconditional -5% target.
Level of carbon pollution caps	If the *Clean Energy* Act remained in place and if caps consistent with the -25% option were implemented, they would need to be accompanied by the removal of the 50% limit on use of international units by liable parties. In the absence of such a change, Australian carbon prices would rise above international levels, disadvantaging trade exposed industry and violating the principle of least cost abatement. It would remain vital to continue free allocation under the Jobs and Competitiveness Program for as long as it was needed in light of actual carbon constraints on relevant international competitors.

For any questions about this submission, the appropriate contact is [redacted]

Yours sincerely,

Innes Willox
Chief Executive

Ai Group Climate Policy Principles

The Australian Industry Group's key climate policy principles are, at their highest level, centred on the preservation of competitiveness; least cost abatement; energy security; fostering research, development and deployment of low-carbon technologies; and minimisation of compliance burdens. These top-level principles have more detailed implications, like the need for climate policy to avoid simply adding to general-purpose revenue.

Ai Group's National Executive has endorsed the following framework as a basis for assessing proposed climate policies. Bolded text is a principle, underlined text is an elaborated sub-principle, and subsequent text is explanatory.

1. Australia should ensure that its emissions reduction effort is in line with the action and ambition of other major economies.

This includes taking into account the extent to which major emerging economies are constraining their emissions and whether efforts by advanced economies are comparable to our own.

Australian climate policy should be flexible so that it can be adjusted in response to the actual level of emissions reduction action and ambition in major advanced and emerging economies.

For example, weaker action or ambition in these economies should lead to lighter burdens on Australian business. Conversely, policy should be able to strengthen if warranted.

Australia should develop and promote a credible basis for assessing and comparing the efforts of different countries. Regular reviews are needed.

2. The competitiveness of Australia's trade-exposed industries cannot be eroded.

a. Global action is fundamental to preserving Australian competitiveness and should be actively promoted in international forums. The starting point for maintaining competitiveness is global action. Even strong measures aimed at trade exposed industries cannot maintain Australian competitiveness over the long term without global action; eventually, the burdens of maintaining such policies while cutting national emissions would become insupportable. Governments should use every opportunity, including though the G20 to push for global action.

b. Neither Emissions Intensive Trade Exposed industries nor the broader trade exposed sector should be unfairly disadvantaged against overseas competitors while global action remains patchy. All major economies have pledged targets or actions, but while mostly significant, these are not yet sufficient to prevent serious competitive impacts from an Australian carbon constraint. Strong measures are needed to maintain the position of Australia's most vulnerable industries against unconstrained competitors. While different specific measures may be appropriate for the most emissions intensive industries and for the broader trade exposed sector, measures for the latter should be no less effective.

c. Policy should build Australia's long-term competitiveness, including in energy. Even under a globally consistent carbon constraint, long-term Australian competitiveness will be damaged unless we adapt effectively to a low carbon global economy. An important part of this will be ensuring a continuation of Australia's advantage in relatively cheap energy. Policy should support an efficient pathway to energy sources that will be globally competitive in the long term under a carbon constraint, whether that turns out to mean gas or coal with carbon capture, renewables, or even nuclear energy. Investments in infrastructure for the transmission and distribution of energy must modernise these systems to capture the benefits of decentralised generation, greater flexibility in fuel sources, and effective management of demand and supply.

3. Australia should be able to meet its international emissions reduction commitments at least cost.

a. Policy should cover the broadest practical base of emissions. The more emissions are covered by policy, the more widely abatement action and costs can be spread. While practical factors may narrow the base, this intensifies the abatement burden for covered sectors.

b. Policy should drive all credible and internationally recognised forms of abatement. Many forms of abatement are available: reductions using existing or future technology to improve carbon efficiency, sequester carbon in the landscape or change energy generation; behaviour change; and imported abatement. Minimising costs requires that all these options be open and that they compete for resources on a common basis. The economic cost to Australia of emissions reduction is only justified if it contributes to an international mitigation effort that reduces climate change. If we rely on abatement that is not recognised as meeting Australia's commitments, we must either undertake additional abatement at further expense, or risk undermining the international framework that justifies the cost of abatement.

c. Market mechanisms will generally be most efficient in locating and driving least cost abatement. While regulation or direct government funding can have a role in some circumstances, bureaucratic or political decision making are usually poor substitutes for the judgments of market actors responding to price in light of their own circumstances.

d. Complementary measures should be adopted only where they can achieve abatement at lower cost than market mechanisms, or enable markets to work more efficiently. Markets will not work in every instance, and they can be made to work better – for instance through measures to address information gaps or agency problems. Such interventions should be chosen with care to ensure they actually minimise costs.

e. Any interim measures preceding a long-term climate policy should be consistent with longer-term policy directions, have acceptable start-up and phase-out costs and must achieve least cost abatement, including on a net present value basis, to ease the transition to longer term policy. There is a role for interim measures in the lead-up to a long-term mechanism, but these can easily turn out to be high-cost or more trouble than they are worth to bring in and phase out.

f. Distortions and perverse incentives should be minimised, especially those that discourage early movers. While climate policy is intended to correct a market failure, it can easily introduce failures and distortions of its own if not carefully designed. Abatement incentives can be positive or negative, but they must be allowed to operate, rather than being blunted, if abatement is to be least cost. Policy must also avoid creating incentives to defer or drop abatement investments that would most efficiently be made now.

g. Climate policy should not increase the state share of GDP, and any resulting revenue should either be returned to individuals and business, or used where necessary and cost-effective to address legitimate needs directly related to climate policy. Some plausible forms of climate policy would raise revenue for the Government, but simply increasing state revenue and general spending is likely to detract unnecessarily from growth, dynamism and overall welfare. Climate policy will entail important spending needs, such as assistance to households and severely affected industries to address equity concerns, assistance to trade-exposed industries to address competitiveness impacts, funding for research and development, and other matters directly related to climate policy. Any such spending should be efficiently designed to minimise the overall costs of mitigation, and any surplus should be returned to the economy – including through reductions in other taxes.

4. Climate policy must respect existing investments to avoid acute short-medium term disruptions while supporting efficient long-term investment in the energy and other sectors

a. A clear, predictable and well designed long-term policy is vital for business to make efficient long-term investment. Perfect certainty is unachievable, and the quality of policy is vital, but there is no doubt that substantial uncertainty over the timing and direction of climate policy is a serious barrier to investment in energy and other major industries across the economy.

b. Policy should provide a clear and supportive environment for new energy investment. The problems of policy uncertainty are especially serious in the energy sector. Forward looking investors need reasonable confidence about the regulatory environment that will apply over the life of their investment. That environment must be a supportive one, however, if investment is actually to result.

c. Any carbon pricing policy should balance price certainty and flexibility. Price flexibility allows savings if abatement costs are lower than projected, and a better match with changing economic conditions. However, too much volatility and price risk – on both the upside and downside – will harm investment.

d. Policy should smooth shocks in the energy sector, ensure that any generation exit is orderly and satisfy existing investors' legitimate expectations. Sudden shocks from climate policy may cause intense difficulties for some generators. This would mean risks to near-term energy security, impose serious loss on existing investors, increase the cost of transition and dissuade future investment. Policy should smooth shocks and satisfy investors' legitimate expectations. The impacts of structural adjustments in the energy sector on affected companies and communities must also be addressed.

5. A central feature of policy should be supporting research and development of new approaches to emissions reduction and refinement of existing approaches.

a. A market for low-carbon goods and services is necessary for broad-based innovation. The development of low-carbon products and technologies will be severely constrained unless innovators are confident that a low-carbon product will be more profitable than a high-carbon substitute. The existence of an actual market is a more plausible spur to innovation than the unpredictable availability of year-to-year grants or subsidies.

b. Additional support is needed to reflect spillover benefits from carbon innovation and the high costs of commercialising some new technologies. Even with a market reward, low-carbon R&D produces benefits for society at large that the researcher cannot capture. If R&D is not to face underinvestment, further assistance will be needed, whether through the tax system, grants, prizes or otherwise. Some promising technologies, including renewable energy technologies and carbon capture and storage, require significant support through demonstration and deployment phases if they are to achieve their potential.

6. Compliance costs and regulatory burdens should be kept to a minimum.

a. Policy should achieve maximal coverage with a minimum of parties directly involved or regulated. While all Australians and companies are responsible for greenhouse emissions to some degree, administrative costs and burdens would be insupportable if more than a small fraction of emitters were directly regulated or liable under carbon policy.

b. Policy should rely on existing data and reporting systems wherever possible, with any new processes imposing the minimum additional burden necessary for good governance. While policy needs information to operate, a great deal is already collected and new requirements for additional or slightly different data can easily become very costly. Processes to judge difficult concepts like 'additionality' are especially likely to be expensive, time consuming and inflexible.

c. Policy should drive the elimination and avoidance of unnecessary, duplicative and unduly burdensome climate regulation. A vast array of largely uncoordinated climate policy already exists and the political incentive for more is constant. Much of this would be unnecessary or avoidable under a broad long-term policy.